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RADICAL TAX REFORM, MUNICIPAL FINANCE, AND THE CONSERVATIVE AGENDA

Eric J. Gouvin*

Proponents of a consumption tax system to replace the federal income tax typically couch their support for radical tax reform in the language of traditional tax policy goals. They claim that their reform plans promote the goals of simplicity, economic efficiency, stability, and equity. This Article examines how well the proposed tax reforms will achieve those goals in the context of their anticipated impact on state and local finance. The effects on state and local governments of a flattened-rate income tax, flat tax, or a broad federal consumption tax could be enormous and devastating. The Article finds that all of the reform proposals fall far short of achieving the traditional goals of tax policy in the context of state and local finance.

This Article develops an alternative explanation for why the radical tax proposals are currently under serious consideration. It suggests that the adverse impact that the federal-level reforms will have on state and local finance is not an incidental side effect, but rather is part of a strategy consistent with conservative thinking to reduce the size of government and to make taxation more difficult. The alternative explanation views the tax proposals as a way to advance the conservative political agenda on at least two fronts: (1) to remove tax expenditures as a policy tool and thereby reduce the opportunities for "social engineering" by the central government; and (2) to force a realignment of federalism issues in the taxation area by making the total tax burden more transparent and making local taxation more difficult.

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I. INTRODUCTION AND PLAN OF PAPER

For approximately the past ten years, radical reform of the federal tax system has been a perennial policy topic in Washington. Some of the proposals under discussion call for a "flattened tax" based on our current income tax system; some look to implement a "flat tax" that would tax business cash flow and individual wages at a proportional, rather than a progressive rate; still others would seek to replace the entire system with a sales tax or value added tax. Many of these same ideas were given serious consideration in the early 1980s, and the result was the "flattened" income tax structure contained in the 1986 Tax Act. Until recently, however, a wholesale

1. Politicians from across the political spectrum have been vigorously proposing major overhauls to the federal income tax system. In an Issue Brief dated February 21, 2003, the Congressional Research Service identified eleven different tax reform proposals ranging from Rep. Gephardt's "flatter" tax proposal, through the more orthodox "flat tax" proposals of Representatives Armey & Shelby and Senator Specter, and on to the more radical ideas of a National Sales Tax and Value Added Tax. See JAMES M. BICKLEY, FLAT TAX PROPOSALS AND FUNDAMENTAL TAX REFORM: AN OVERVIEW, 5-11 (Cong. Research Serv., Rep. No. IB95060, 2003) [hereinafter CRS OVERVIEW], available at http://www.ncseonline.org/nle/crsreports/03apr/ib95060.pdf. In addition to the airing it has received on Capitol Hill, this complex subject has received an astounding amount of attention in the popular press as well. The public fascination with the idea of a flat tax may have been the product of media attention and not the other way around, but, in any event, the popular press has covered the issue with enthusiasm since at least the 1996 presidential race. See Nancy Gibbs, Knock 'Em Flat, TIME, Jan. 29, 1996, at 23 (discussing the campaign of Steve Forbes and his pet project, the flat tax). Candidate John McCain promoted the idea of a flat tax in his presidential campaign in 2000. James K. Glassman, Who's the Flat-Tax Candidate? John McCain, WALL ST. J., Mar. 1, 2000, at A26. At the other extreme, even noted tax scholars see the U.S. tax system as being ripe for change. Michael J. Graetz, 100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System, 112 YALE L.J. 261, 261-62 (2002).

2. See discussion infra Part I.A.1.

3. See discussion infra Part I.A.2. While recent proponents have characterized the flat tax as a new proposal, it is an idea that has been around since before the modern income tax was established in 1913. See Steven A. Bank, Origins of a Flat Tax, 73 DENV. U. L. REV. 329 (1996) (providing an excellent history of the income tax in the United States with special attention to recurring debates over progressivity and proportionality). Economist Milton Friedman has been advocating a proportional tax for almost 40 years. See MILTON FRIEDMAN, CAPITALISM AND FREEDOM 174-76 (1962) (advocating a flat rate income tax after a large personal deduction, together with the elimination of the corporate income tax, as a way to eliminate tax-related distortions in the economy and reduce tax evasion and tax avoidance).


5. See Slade Gorton, Tax Reform and the Tax Legislative Process, in OPTIONS FOR TAX REFORM 33, 37 (Joseph A. Pechman ed., 1984) (noting the popularity of the flat tax idea in the early 1980s and characterizing the Bradley-Gephardt tax proposal, which eventually became the 1986 Tax Act, as a "modification of the flat tax proposal.").
shift in federal tax policy from progressive income taxation to some other, more proportional, approach has not enjoyed serious political backing.  

A major thread in the current debate is a move away from "income" taxation and toward consumption taxation.  

This round of tax proposals appears to be only the latest episode in a long line of tax revolts that have punctuated American history.  

If the proponents of tax reform see the income tax itself as the enemy, however, they may be in for quite a fight. In the ninety years since its enactment, the income tax has taken on a life of its own and grown to become the most important source of federal revenue.  

6. Progressivity has been built into the federal income tax since the very beginning and was intended at the time of enactment to promote an overall tax burden that was roughly proportional, given that the dominant form of federal revenue raising at the time, tariffs, was widely perceived to be regressive. See Bank, supra note 3, at 377 (noting the idea of making the overall tax burden proportional, and in the article as a whole, documenting the political support, or lack thereof, for proportional taxation over the years).

7. For an excellent article placing consumption taxing into the broader context of taxation theory, see generally Robin Cooper Feldman, Consumption Taxes and the Theory of General and Individual Taxation, 21 VA. TAX REV. 293 (2002).


9. See Marjorie E. Kornhauser, The Rise of Rhetoric in Tax Reform Debate: An Example, 70 TUL. L. REV. 2345, 2360 n.27 (1996) (noting the fact that despite two false starts, federal level consumption taxes have not been given serious consideration).


interest in the status quo, making wholesale reform of the federal taxation scheme extremely difficult from a political perspective.\textsuperscript{12}

On the other hand, people will always hate to pay taxes, especially high taxes. History has borne this out in the context of the income tax. Congress reduced the tax base during the 1950s, 1960s, and 1970s by granting exemptions, deductions, and credits to implement various social policies and political compromises. Yet even as the tax base dwindled, the federal budget continued to rely heavily on the revenue stream from the income tax. Congress raised marginal tax rates in order to secure the needed government revenue.\textsuperscript{13} As tax rates increased and loopholes proliferated, a whole industry of tax lawyers, tax accountants, and tax shelter promoters evolved with the sole purpose of reducing or deferring tax liability.\textsuperscript{14} As the tax avoidance industry grew, more and more people came to have a stake in maintaining the status quo of the tax code. At the same time, however, enough people became concerned by high marginal rates, among other matters, to force a re-reexamination of the income tax in the late 1970s and early 1980s. At that time, commentators and policymakers began to talk seriously about a flat tax\textsuperscript{15} and consumption taxes.\textsuperscript{16}

When the flat tax movement came to life in the early 1980s, it was in no small part a reaction to the tax shelter industry and the combination of tax preferences and high marginal tax rates that

\textsuperscript{12} See Milton Friedman, \textit{Why a Flat Tax is Not Politically Feasible}, WALL ST. J., Mar. 30, 1995, at A14 (opining that a flat tax will never be enacted because of opposition from organized special interest groups and because Congress profits by selling tax breaks to political supporters).

\textsuperscript{13} Simple algebra informs us that in order to get the needed revenue, \(X\), where \(X\) is the product of tax base \((B)\) times the tax rate \((R)\) if \(B\) is made smaller, \(R\) must be made larger in order to produce the same outcome, \(X\).

\textsuperscript{14} See, e.g., David M. Einhorn, \textit{Unintended Advantage: Equity Reits vs. Taxable Real Estate Companies}, 51 TAX LAW. 203, 217 (1998) ("Another result of the tax incentives, a result that was not desired and probably not anticipated was the development of a very substantial tax shelter industry.").


\textsuperscript{16} See RICHARD GOODE, \textit{THE INDIVIDUAL INCOME TAX} 11-36 (rev. ed. 1976) (questioning the validity of income as a measure of tax responsibility and arguing for the use of alternative bases such as consumption or wealth); Gordon D. Henderson, \textit{Alternatives to the Income Tax}, in \textit{OPTIONS FOR TAX REFORM}, supra note 5, at 78 (discussing flat taxes, consumption taxes and other alternatives); Henry J. Aaron & Harvey Galper, \textit{A Tax on Consumption, Gifts and Bequests, and Other Strategies for Reform}, in \textit{OPTIONS FOR TAX REFORM}, supra note 5, at 106 (discussing various income tax alternatives); William D Andrews, \textit{A Consumption-Type or Cash Flow Personal Income Tax}, 87 HARV. L. REV. 1113 (1974) (making the argument that a consumption tax would be fairer than the income tax).
made tax shelters work. Proponents of the flat tax wanted to stop what they perceived to be unfair tax breaks and economically inefficient business deals that were driven more by tax considerations than by economics. The 1986 attack on tax shelters was multi-pronged, but its two key elements were right out of the flat tax playbook: (1) broaden the tax base by eliminating or reducing the tax incentives that attracted tax shelter investments; and (2) lower marginal tax rates to reduce the value of tax losses. The flatter tax that was enacted in 1986 did indeed make the bogeyman of tax shelters disappear.

Yet even after the broad changes brought about by the 1986 tax law, people remained dissatisfied with the tax system. Politicians have exploited that public discontent by pushing their various radical reform proposals designed to completely replace the existing income tax scheme. Because the truly abusive tax avoidance problems of the pre-1986 era have been put to rest, today's proponents of flat rate

17. See, e.g., ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 32-39 (1st ed. 1985) (citing, as reasons for adopting the flat tax proposal, the inequity in tax shelters and in the treatment of capital gains as well as the complexity of the pre-1986 tax code).

18. Id. at 24, 32-36.


20. See id.

21. See Mona L. Hymel, Tax Policy and the Passive Loss Rules: Is Anybody Listening?, 40 ARIZ. L. REV. 615, 617-27 (1998) (giving a concise history of abusive tax shelters and the legislative response thereto, and concluding that the tax shelter industry of the 1970s and 1980s is dead). Congress frequently enacts changes to the tax laws that target specific tax planning strategies, including, but not limited to, tax shelters. Whether those changes to the law are necessary to curtail abuses or merely add complexity to the tax code without enhancing fairness or efficiency depends on the overall context in which the law and the transactions exist, including the transaction costs or other frictions the taxpayer will encounter in trying to avoid the rule. See David M. Schizer, Frictions as a Constraint on Tax Planning, 101 COLUM. L. REV. 1312 (2001) (discussing “frictions,” which are tax planning constraints outside of the tax law, and their effects on the taxpayers).

taxes must offer a new rallying cry if they have any hope of implementing the new taxation schemes they champion. They claim that their reform plans promote the traditional tax policy goals of simplicity, economic efficiency, stability, and equity. This Article examines how well the proposed tax reforms will achieve those goals in the context of their anticipated impact on state and local finance. The effects on state and local governments of a flattened-rate income tax, flat tax, or a broad federal consumption tax could be enormous and devastating. This Article finds that the reform proposals all fall far short of achieving their purported goals in the context of state and local finance.

In light of the political philosophy of the radical tax reformers, the adverse impact on state and local finance may not be an incidental side effect of federal tax reform. Instead, the disruptive effects the proposed federal changes will have on municipal finance may be part and parcel of a strategy to reduce the size of government by making the total tax burden more visible and making local taxation more difficult. This Article develops an explanation for why the radical tax reform proposals are currently under serious consideration. The explanation views the tax proposals as a way to

23. Indeed, while many proponents of tax reform would like a wholesale revision of the current scheme, John D. McKinnon, Treasury Weighs Huge Changes in U.S. Tax Code, WALL ST. J., Oct. 30, 2002, at A2, it may be that the radical reformers have recognized the reality that public dissatisfaction with the current scheme is not sufficiently fervent to allow immediate implementation of any radical new taxation program, Bruce Bartlett, Tax Torture Is Flat Wrong, WALL ST. J., Apr. 15, 2002, at A16 ("[M]ost flat-tax supporters have moved away from scrapping the code completely and adopted a gradualist approach."). Indeed, while President Bush has indicated support for a consumption tax of some kind, Greg Ip, Bush Floats Shift to Consumption Tax, WALL ST. J., Feb. 10, 2003, at A3; he appears to be proposing an incrementalist strategy to achieve his tax goals, Howard Gleckman, Inching Toward Tax Reform: President Bush Wants Big Tax Changes—But in Small Increments, BUS. WK., Dec. 16, 2002, at 32.

24. Although the exact formulation of the attributes of a good tax system vary, commentators almost always include "equity," "efficiency," and "simplicity," together with some other attribute or two, which often serves as a catch-all for other desirable aspects of a tax system. I have decided to call my catch-all category "stability." But see J. Kenneth Blackwell, Keynote Address, Seton Hall Legislative Bureau—Flat Tax Symposium, 20 SETON HALL LEGIS. J. 273, 276-77 (1996) (reflecting the views of the author, a member of the Kemp Commission on Economic Growth and Tax Policy, identifying six requirements for any tax reform proposal: simplicity, fairness, neutrality (what I've called efficiency), visibility (discussed later), stability, and freedom for growth (included in my listing of efficiency)); see also STAFF OF THE JOINT COMM. ON TAXATION, 104TH CONG., DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX 58 (Comm. Print 1995) (noting that the criteria for judging a tax system are economic efficiency, fairness (including both horizontal fairness and the ability to pay taxes), simplicity, and the ease of administration, enforceability, evasion (this could be thought of as being included in stability)).
advances the conservative political agenda on at least two fronts: (1) to remove the policy tool of tax expenditures from the Congress and thereby reduce the opportunities for "social engineering" by the central government; and (2) to force a realignment of federalism issues in the taxation area by making the total tax burden more transparent and making local taxation more difficult.

This Article begins with a quick overview of the major types of tax reform proposals currently under consideration in Congress. It then turns to a discussion of how these proposals would affect various aspects of state and local finance. The third section discusses the proposals and their effects in light of the traditional policy goals of equity, efficiency, simplicity and stability and finds that with regard to the impact on state and local finance, the reform proposals do not achieve any of the purported policy goals. The last section discusses conservative political principles and describes how a radical tax reform would advance those ideals even if it does not advance the traditional goals of good tax policy.

A. Overview of Current Proposals

This Article will not duplicate the efforts of the many books and articles examining and comparing the major tax reform proposals. Nevertheless, while in-depth analysis of individual proposals is beyond the scope of this Article, it may be useful for our purposes to identify the four major categories into which the major proposals fall:

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1. The Flattened Income Tax

The first, and least radical, tax reform plan is the one proposed in the 105th Congress by Representative Dick Gephardt\(^2\) to continue the base broadening and rate flattening process he championed in the years leading up to the passage of the Tax Reform Act of 1986.\(^2\) Although this plan would continue to employ income as the tax base, it would bring radical changes to the income tax as currently configured. Under this plan, all itemized or individual deductions (as opposed to the "above-the-line" deductions), except the home mortgage interest deduction, would be eliminated to make the income tax base quite broad.\(^2\) Marginal rates would be lowered to a range of twenty- through thirty-four percent, with three quarters of the population paying an effective rate of ten percent.\(^2\)

2. Hall/Rabushka-Inspired Flat Taxes

The second group of proposals are those inspired by the "flat tax" proposal developed in the 1980s by Hoover Institution scholars Robert E. Hall and Alvin Rabushka.\(^3\) The flat tax proposals from Representative Richard Armey\(^4\) together with Senator Richard Shelby\(^5\) and the version from Senator Arlen Specter\(^6\) seem to fit the Hall/Rabushka model. Some of the ideas advanced by 1996 presidential hopefuls Steve Forbes and Pat Buchanan probably belong in this category as well.\(^7\)

These plans vary but they share the attribute of moving away from income taxation and toward consumption taxation.\(^8\) The plans

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27. See Richard A. Gephardt, The Bradley-Gephardt Fair Tax, in OPTIONS FOR TAX REFORM, supra note 5, at 74 (describing Representative Gephardt's push for a broader based, lower rate income tax in the early 1980s).
29. See CRS OVERVIEW, supra note 1, at 8-9; RICHARD GEPHARDT, AN EVEN BETTER PLACE 171-72 (1999).
30. See HALL & RABUSHKA, supra note 15, at 52-103 (describing their tax plan).
35. A noted tax scholar has opined that the Hall/Rabushka model suffers from major design flaws that will make it impracticable as an effective revenue raising mechanism. See generally David A. Weisbach, Ironing Out the Flat Tax, 52 STAN. L. REV. 599 (2000) (noting, among other things, that the Hall/Rabushka tax is easy to
would repeal the current individual and corporate income taxes, along with the estate and gift tax and replace them with a wage tax and a cash-flow tax on business. The wage tax would only pick up wages, salary, and other compensation; it would not cover dividends, interest, capital gains, or other returns to investment. The plans would eliminate all individual deductions in their current form but could provide for progressivity through a series of family exemption allowances. The business activities tax would exempt investment income from tax but would otherwise tax all receipts less the costs of purchases from other businesses, wages, and pension contributions. The tax rate for both components would be around twenty percent.

3. The Unlimited Savings Allowance (USA) Tax

The third category is the unlimited savings allowance (USA) tax which was originally introduced in the 104th Congress by Senators Sam Nunn, Pete Domenici, and J. Robert Kerrey, and was championed in subsequent Congresses by Representative English. The USA tax is also a consumption tax, but it works a bit differently than that the Hall/Rabushka plan. It taxes businesses on gross profits—actual receipts less actual disbursements. It does not, however, permit the business taxpayer to deduct employee compensation and fringe benefits in calculating the taxable amount, although it does provide a credit for payroll taxes. At the individual level, the USA tax taxes wages, salaries, commissions, life insurance proceeds, reductions in savings, fringe benefits, capital gains, interest, and dividends. It retains some of the popular deductions and exclusions from income, including the deduction for home mortgage interest and the exclusion of interest on state and local bonds. It also allows individual taxpayers to reduce their taxable

avoid, which will lead to inefficiency, complexity, higher rates, and a shift in the distribution of the tax burden).

36. See Abreu, supra note 25, at 1361-62 (discussing the decision to specify a narrow tax base).
37. All tax rate estimates should be taken with a grain of salt. See generally Lawrence Zelenak, The Selling of the Flat Tax: The Dubious Link Between Rate and Base, 2 CHAP. L. REV. 197 (1999).
40. Id. § 301.
42. See Abreu, supra note 25, at 1366 nn.34-35 (describing the deductions and exclusions under the USA tax); Richard J. Joseph, The “Consumption Tax and Flat” Taxes Revisited, 69 TAX NOTES 211-12 (1995); Lee A. Sheppard, The Consumption Tax:
income by the amount of money they have saved each year. In this way, it aims to tax the amount of income that was consumed.\textsuperscript{43}

4. Value Added and Retail Sales Taxes

The fourth and final group of proposals are those calling for a National Retail Sales Tax ("NRST") or a Value Added Tax ("VAT"). A proposal for an NRST has been introduced by Representative Billy Tauzin.\textsuperscript{44} Senator Richard Lugar has also advocated an National Sales Tax.\textsuperscript{45} A transactional VAT similar to those employed in many European countries\textsuperscript{46} would have an impact on states similar to that of an NRST. Discussions on Capitol Hill have included a VAT as one of the possibilities for revamping the federal tax system, but reform proponents have not been employing that terminology to describe their proposals.\textsuperscript{47} Issues arising under these taxes, which seek to tax all consumption, include: the logistics of trying to capture all transactions in goods and services in a sprawling complex economy; the availability of tax exemption for sub-federal government units; and the need to avoid the cascade problem of taxing goods that pass through other levels of government.

\textit{Borrowing as a Tax Shelter}, 68 \textit{TAX NOTES} 138-41 (1995) (discussing debt issues in both Flat Tax and USA Tax).

\textsuperscript{43} See Murray Weidenbaum, \textit{The Nunn-Domenici USA Tax: Analysis and Comparisons in FRONTIERS OF TAX REFORM}, supra note 25, at 54, 54-57 (describing the underlying philosophy of the USA tax and providing an illustration of how the tax would be calculated).

\textsuperscript{44} H.R. 2717, 107th Cong. (2001).

\textsuperscript{45} S. Res. 16, 105th Cong. (1997).

\textsuperscript{46} A Value Added Tax is a mechanism for including all of the output of the economy; in effect the tax base is national income. \textit{See JOSEPH A. PECHMAN, TAX REFORM, THE RICH AND THE POOR} 117-20 (2d ed. 1989) (providing an overview of value added taxation including a summary of how the tax base is adjusted for investment expenditures and how individual returns are adjusted to capture the value added by the taxpayer).

\textsuperscript{47} Of the proposals receiving serious attention on Capitol Hill, both Representative Armey's proposal, H.R. 1040, 107th Cong. (2001), and Senator Specter's proposal, S. 822, 106th Cong. (2000), are essentially subtraction-method value added taxes, where "purchases are subtracted from sales and the tax rate is then applied to the net figure," \textit{PECHMAN}, supra note 46, at 118. Neither proposal, however, identifies them as such. Former Representative Gibbons had introduced a bill for a Value Added Tax in the 104th Congress. H.R. 4050, 104th Cong. (1996). The proposals that have been made thus far attempt to integrate some of the VAT principles into a two-level, business and individual tax as a purported replacement for the income tax. \textit{See generally Lester B. Synder \\& Marianne Gallegos, Redefining the Role of the Federal Income Tax: Taking the Tax Law "Private" Through the Flat Tax and Other Consumption Taxes}, 13 \textit{AM. J. TAX POL'Y} 1 (1996) (discussing proposals that rely "on a combination VAT and income tax base").
through many hands (and may be taxed at each step) on their way to the ultimate consumer.\textsuperscript{48}

Each of the proposals outlined above takes a different tack in the course of raising federal revenue. Because of the differences among the various proposals, they will affect state and municipal finances in different ways. Even with that caveat, there are some effects from each of the proposals that one can anticipate.

II. LIKELY EFFECTS OF RADICAL TAX REFORM ON STATE AND LOCAL FINANCE

The effects of reform plans that call for moving away from income taxation and toward consumption taxation will be felt far beyond the federal treasury. The proposals will affect state and local finance in several ways, including by making state and local income taxes more difficult to administer, by curtailing state and local revenue sources, by disrupting the tax exempt municipal bond market, and by hampering the ability of states and municipalities to export their tax burdens through federal deductibility.

A. The Effective Repeal of State and Local Income Taxes

State and local governments derive a significant portion of their tax revenues from state and local income taxes. The informational infrastructure necessary to administer such tax schemes is complex, however, so virtually all state and local income taxes "piggyback" on the federal income tax for much of the administrative mechanism needed to implement such taxes in a fair and efficient manner.\textsuperscript{49} State and local tax authorities rely on the federal income tax infrastructure in many ways. For example, state and local tax agencies utilize federal regulations defining "taxable income and allowable deductions," receive copies of taxpayer filings prepared for federal authorities, and receive the benefits from both federal audits and from legal enforcement actions brought by federal authorities against taxpayers.\textsuperscript{50} They also tap into the national framework of


\textsuperscript{49} See Holtz-Eakin, \textit{supra} note 41, at 128-29 (discussing the piggyback effect and noting the difficulty with which any given state could maintain the informational infrastructure necessary to tax income at the state level if there were not federal tax system).

informational reporting even though they lack the legal authority to compel reporting from nonresident corporations and other entities.\textsuperscript{51} Given the immense administrative costs of an income tax system, it seems unlikely that any individual state could retain a traditional individual or corporate income tax on its own.\textsuperscript{52}

Although all of the current reform proposals could have potentially devastating effects on state and local income taxation efforts, it should be noted that the proposals differ in the degree to which they hobble existing state and local income taxes. The Gephardt flattened tax and the USA tax would leave in place the essential national income reporting system and that alone would likely permit states to continue to administer their own income taxes. Both of these proposals, however, would cause radical changes in the definition of the tax base in a way that might not coordinate well with the public policy of individual states. The benefits of the current “piggyback” approach would be largely lost if the states chose to define the tax base in a method inconsistent with the new federal base definition and especially if the states desired to exempt from tax, or tax at a differential rate, a component of income no longer considered special under the federal scheme. In those situations, obtaining at the state level the information needed to administer the tax (especially from non-resident businesses) would be logistically (and perhaps legally) difficult.

The Hall/Rabushka-inspired plans and the National Sales or Value Added Tax, if enacted, would spell disaster for state-level income tax programs. Because federal tax changes that depart radically from the traditional model of income taxation would have no need for the types of data needed to run an income tax, one would assume the federal government will stop collecting that data and therefore the federal informational infrastructure necessary for the administration of a state income tax would be lost completely. There may be some solace for states in that both the USA tax and the

\textsuperscript{51} Id. at 1461.

\textsuperscript{52} Id. One could contemplate the continuance of state income tax systems where Congress either makes changes to the current system but leaves the informational infrastructure in place or where the states form a compact among themselves to pool their individual jurisdictional authorities and create a nationwide information reporting system. See id. at 1475 (discussing the interstate compact idea). In any event, if state-level income taxation is to continue, it would require some extraordinary mechanism to permit it to do so. Even under the existing tax system, states are finding their traditional methods of determining tax nexus, tax bases, and activity allocation increasingly anachronistic in the Internet age. Without some kind of interstate coordination of tax information, the current system may be hobbled. See Robert J. Cline, \textit{Can the Current State and Local Business Tax System Survive the New Economy Challenge?}, 24 \textit{State Tax Notes} 241 (Apr. 15, 2002) (commenting on the difficulties facing states whose tax agencies must adapt to economic changes).
various Hall/Rabushka style flat tax bills would permit states to substitute a broad-based, apportioned, state-level subtraction-method value added tax for their existing corporate income taxes and thereby piggyback on that informational infrastructure. More extreme forms of federal taxation reform, however, such as a national retail sales tax or a European-style value added tax, would likely force the states to repeal their corporate and individual income taxes as well.\footnote{53}

Congress seems to be largely unconscious of the effect that wholesale federal income tax reform will have on state and local governments' ability to levy income taxes. In the Joint Committee on Taxation's study examining the impact of federal income tax reform on state and local governments,\footnote{54} there is only a brief mention of the difficulties state and local governments would have in administering income taxes in the absence of a federal income tax infrastructure.\footnote{55} In light of the seriousness of the disruption such a change would cause, the ramifications of federal tax law changes on state level tax schemes should receive much more attention.

B. Curtailing Other Revenue Raising Options

Fundamental changes at the federal level will cut off some revenue-raising options at the state and local level. The imposition of a federal sales tax or value-added tax ("VAT"), for example, in addition to depriving state and local governments of the option to tax income effectively, will precipitate other revenue-raising problems. Given state and local governments' dependence on sales tax revenues, the addition of a federal level tax on top of existing state

\footnote{53} Even in these extreme situations, if Congress repealed the federal tax without repealing the federal income tax reporting system, states might nevertheless remain able to carry out their income tax schemes. \textit{See} Mazerov et al., \textit{supra} note 50, at 1462 (opining that absent a decision by Congress to leave reporting schemes intact, a decision to repeal the federal income tax would force states to repeal their income taxes).

\footnote{54} \textit{Staff of Joint Comm. on Taxation, 104th Cong., Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax} (Joint Comm. Print 1996).

\footnote{55} While the Joint Committee on Taxation was aware of the essential role the federal income tax plays in the administration of state income taxes and the potential repercussions of federal changes for the states, they nevertheless did not consider the implications of scrapping the federal infrastructure to be worthy of more than a sentence. \textit{Id.} at 70 (noting that "[b]ecause most of the States that collect individual and corporate income taxes model their State income tax systems after the Federal income tax system, any significant restructuring of the Federal income tax system could have considerable corollary implications for such States"). Without any real analysis, the Committee Report merely noted that "the elimination of a Federal income tax . . . would entail a considerable increase in the complexity and expense of administering a State income tax system." \textit{Id.}
and local taxes will create severe policy problems for state and local tax authorities. Canada experienced similar problems when it adopted a VAT in 1991. The issues raised by the imposition of a federal level sales tax or VAT primarily include eliminating competition and promoting coordination between the federal level tax and the state and local taxes. A big issue will be how to make the tax bases of the two systems similar enough to avoid major compliance problems.

The reality of a combined state and federal sales tax or VAT would be a very visible and very large incidence of tax on each and every transaction in goods and services. Taxpayers will be reminded of the cost of government over and over again in a much more immediate way than they are when their income taxes are automatically withheld from their paycheck every two weeks. This could have several effects on tax policy, including: (a) a "crowding out" effect in which the federal tax plus the local tax creates "political pressure for immediate reductions in state and local sales taxes"; (b) "political pressure brought by the business community" (which must collect the sales and VAT taxes) for conforming the state and local sales tax base with the federal base "or elimination of the state/local sales taxes entirely"; and (c) administrative issues with federalism overtones if states are charged with administering the federal sales tax scheme.

While the sales tax and VAT approaches are most worrisome, all of the reform proposals raise problems for local property taxation schemes. To the extent that base-broadening plans eliminate the home mortgage interest and property tax deductions, property values

56. Of course, in the Internet age, state and local reliance on the sales tax is already problematic. See generally Charles E. McLure, Jr., Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?, 2000 BYU L. REV. 77 (detailing how e-commerce serves to aggravate the defects of the retail sales tax).

57. See Tracy A. Kaye, Show Me the Money: Congressional Limitations on State Tax Sovereignty, 35 HARV. J. ON LEGIS. 149, 182 (1998) ("Canada enacted the GST without the full support and cooperation of all the provinces, and this has caused difficulties."); see also Sean C. Aylward, Proposed GST Reforms in Canada Include Integrated National, Provincial VAT, 5 J. INT'L TAX'N 473, 473 (1994) (noting that at the time of the adoption of the GST, Canada had "ten different broad-base sales taxes, eight provincial single-stage sales taxes (in all provinces except Quebec and Alberta), and two multi-stage sales taxes (the federal GST and the Quebec QST).... Nonetheless, repeated efforts by the [federal] government to negotiate a harmonized National Sales Tax failed to win provincial support.").

58. Mazerov, supra note 50, at 1466-67; see also Holtz-Eakin, supra note 41, at 120 (noting that as five states do not currently impose a sales tax, asking them to collect a federal sales tax would create an awkward situation).
are likely to decrease (certainly in the short term). Because homes are a major component of local real property tax bases, this likelihood could lead to a reduction in local property tax revenues in the absence of offsetting tax rate increases. Of course, these perturbations should only last until the next general assessment, but the resulting readjustment of the property tax rate to make the local budget balance could be politically difficult or even legally impossible, considering that some states impose legal limitations on the power of local governments to raise property tax rates. To complicate matters further, this stress on the property tax regime will occur at a time when state and local tax authorities already face a troubling erosion of the property tax base through federal restrictions and preemptions.

In addition, the far-reaching changes in federal tax incentives could upset long-standing expectations about sales tax revenues at the state and local level. Because one goal of the wholesale shift of the federal tax system from taxation of income to taxation of consumption is to encourage savings and investment, policy makers must worry about the effect that the concomitant expected decrease in consumption would have on tax revenues. Given the key role played by sales taxes in state and local finance, a significant drop in consumption induced by federal tax law changes could reduce significantly state and local revenues from their sales taxes.

59. Dennis R. Capozza et al., Taxes, Mortgage Borrowing, and Residential Land Prices in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 171, 191 (Henry J. Aaron & William G. Gale eds., 1996) (concluding that in the sixty-three metropolitan statistical areas ("MSAs") they examined, property values will decrease about five percent on average but that some MSAs will experience only a two percent decrease while others will lose as much as thirteen percent in value); see Robert Eisner, The Proposed Sales and Wages Tax—Fair, Flat, or Foolish? in ROBERT E. HALL, ET AL., FAIRNESS AND EFFICIENCY IN THE FLAT TAX 42, 75 (1996) ("[T]he elimination of tax deductibility for mortgage interest will hit housing hard."). But see Roberta F. Mann, The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction, 32 ARIZ. ST. L. J. 1347 (2000) (advocating repeal of the deduction on the ground that, as currently constituted, the provision encourages urban sprawl and is not available to all potential home owners and also on the ground that a repeal might induce lower housing prices).

60. The most famous of these restrictions are California's Proposition 13, CAL. CONST. art. XIII §1(a), and Massachusetts' Proposition 2 ½, MASS. ANN. LAWS ch. 59, §21C (Law Co-op. 1990). See also PECMAN, supra note 19, at 277 (noting that "ten states impose limits on local taxes or expenditures").

C. **Effect on State/Local Borrowing**

All of the tax reform proposals would have a profound impact on the municipal bond market. Every federal income tax act since the passage of the Sixteenth Amendment in 1913 has contained an exemption for the interest from the obligations of state and local borrowings from federal income taxation.62 However, although the exemption of state and local obligations from federal taxation has a long pedigree, it is not required by the Constitution.63 Because there is no Constitutional bar to including this source of income, all of the major tax reform proposals except some of the flat tax proposals either reduce (in the case of the USA tax) or eliminate (flattened tax proposals), or render inapplicable (sales tax and VAT) the federal tax exemption for interest paid on state and local government borrowings.64 The impact of eliminating the federal subsidy on the interest expense of state and local government is a matter of debate among economists and policy makers.65 What is not at issue, however, are the observed effects of tax policy changes and anticipated tax policy changes on tax exempt bond spreads—serious talk of tax reform narrows the spread between taxable and tax exempt obligations, apparently as bond buyers incorporate a heavier discount to take account of the possibility of future tax changes.66 In the 1996 presidential campaign, for example, economists observed an inverse

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63. See South Carolina v. Baker, 485 U.S. 505 (1988) (overruling earlier precedent and holding that the Constitution does not require that interest on municipal obligations be exempted from a nondiscriminatory federal tax on bondholders).

64. See JOINT COMM. ANALYSIS, supra note 25, at 83-100 (describing the various proposals).

65. Compare PECHMAN, supra note 19, at 123-27 (describing the debate about the economic justification for the deductibility of state and local bond interest and concluding that such an exemption is economically inefficient because the interest saved by the borrower is less than half the revenue lost by the Treasury) with Maxwell A. Miller & Mark A. Glick, The Resurgence of Federalism: The Case for Tax-Exempt Bonds, 1 TEX. REV. L. & POL. 25 (1997) (eschewing conventional analysis of the tax exemption as a disguised subsidy that creates an economically inefficient transfer and asserting that principles of federalism should preclude the federal-level taxation of state and local obligations).

66. See James M. Poterba, Explaining the Yield Spread Between Taxable and Tax-Exempt Bonds: The Role of Expected Tax Policy, in STUDIES IN STATE AND LOCAL PUBLIC FINANCE 5 (Harvey S. Rosen ed., 1986) (showing that expected changes in tax policy have an important effect on yield spread between taxable and tax exempt securities).
correlation between candidate Steve Forbes' popularity and the tax exempt spread. 67

The importance of tax exempt financing for cities is hard to gauge in dollar amounts, but it is substantial by almost anyone's reckoning. In 1995, the combined debt load of state and local governments in the United States was approximately $1.2 trillion. 68 The federal tax exemption allowed state and local bond issuers to save approximately $12.9 billion in interest costs. 69 Even small changes in the costs of financing an amount that large will translate into a very large number. Yet despite the widely understood negative impact the tax reform proposals would have on the market for municipal debt, only the USA tax makes any attempt to blunt the adverse effect. 70 The other proposals would wreak havoc in the tax exempt market.

Starting with the flattened-rate tax proposal, the base-broadening component of that plan would eliminate the tax exemption for municipal bonds. The effect of such a change would be to force municipal issuers to offer higher yields in order to provide an after-tax return to investors commensurate with the return they could receive from taxable obligations. Even if political pressures were to result in the retention of the exclusion for municipal bond interest, the rate-lowering component of the plan would greatly reduce the value of the tax preference. 71 The implications of lowering...

67. See Joel Slemrod & Timothy Greimel, Did Steve Forbes Scare the Municipal Bond Market? (Nat'l Bureau of Econ. Research, Working Paper No. 6583, 1998) (describing the effect of Steve Forbes' political strength (as measured by the Iowa Electronic Market, which allows participants to trade on political candidates' prospects on the spread of 5 and 30 year municipal obligations and observing a marked contraction of the spread on 5 year obligations whenever Forbes' political fortunes rose, while finding a more muted effect on 30 year obligations), available at http://www.nber.org/papers/w6583.


69. Id.

70. The USA tax would continue to provide an exclusion for tax-exempt interest, but in light of its rate lowering objective, the value of the tax deduction would be diluted significantly.

71. A simple example illustrates this concept. Let's take an investor in a hypothetical high income tax bracket, let's call it forty percent. Let's further stipulate that the investor is faced with an investment choice between two equally risky securities: a taxable bond carrying a ten percent current yield and a tax exempt bond offering a seven percent yield (again, for simplicity's sake let's focus on current yield instead of the more appropriate yield to maturity). In a tax-free world, of course the investor would take the ten percent security, assuming as stated that the issuers are equally risky. But the tax consequences change the dynamics. For the ten percent taxable bond, the effective rate of return is only six percent (interest payment of ten percent minus forty percent taxes). Since the tax exempt bond offers a seven percent
tax rates is obvious—bond yields will go up, and the differential between taxable and non-taxable bond rates will narrow even further. Under the flattened tax plan, state and local borrowing will be adversely affected. Of course, the wealth of current owners of tax exempt securities will be adversely affected as well, as the value of those bonds will fall once the market demands a higher yield to compensate for the lack of tax exemption.

Under the Hall/Rabushka inspired plans and the VAT and retail sales tax, interest on municipal bonds would not be taxed directly either because the interest is explicitly excluded from the tax base or because the focus of the tax base is elsewhere. While on first blush that appears to be good news for tax exempt issuers, the bad news is that all other issuers of debt will be treated the same way. So under the Hall/Rabushka style taxes, the interest on a bond from the City of Boston will not be taxable, but the interest on a bond from a similarly rated private issuer will not be taxed either. The result, as with the flattened tax proposal, will be to eliminate the spread between municipal and private debt obligations.\(^{72}\)

The cost of tax exempt financing to the Federal Treasury has long been a target for tax reformers who want to improve the economic efficiency of the tax system. Yet the elimination of tax exemption will increase burdens at the state-local level. Replacing tax exemption with a federal interest subsidy to municipalities, as has been proposed in the past,\(^{73}\) while sound in theory, will be inefficient and costly in practice due to administration costs and delay. Additionally, if the federal subsidy is not pegged to the correct market rate, it will skew incentives for public borrowing. The logistics of budgeting at the federal level for the subsidies arising out of state and local activity would be formidable. The possibility of official corruption and pork barrel politics are bound to enter any

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\(^{72}\) Whether municipal yields will rise to meet private yields or private yields will fall to meet municipal yields is anyone's guess, but it seems likely that municipalities will incur higher costs of borrowing under a flat tax. See Douglas R. Sease & Tom Herman, The Flat-Tax Primer 93 (1996) (noting the difficulty of predicting price movements in the bond market, but suggesting that municipalities will pay more under a flat tax).

\(^{73}\) See Peckman, supra note 19, at 126 (noting the idea and the approaches to an explicit federal subsidy for state and local borrowing that have been proposed in the recent past); see also Who Profits from Tax-Exempt Bonds?, N.Y. Times, Oct. 14, 1981, at A30 (advocating a direct subsidy to state and local governments). The idea of having the federal government pay thirty to forty percent of the debt interest payments owed by the states on their debt securities was actually proposed in 1969, but was never adopted. Tax Reform Act of 1969, H.R. Rep. No. 91-413, at 172-74 (1969).
subsidy program. Finally, administrative considerations and the lag time of receiving the promised subsidy from the federal government, make interest subsidies an unattractive option for state and local governments.

D. Elimination of Exportability Through Federal Deduction of State and Local Taxes.

All of the tax reform proposals would eliminate the deductibility of state and local income and property taxes in determining a taxpayer's federal tax liability, or render such an adjustment irrelevant to the tax base. Under the current arrangement, taxpayers who itemize are permitted to deduct from their federal taxable income the amount they have paid in state and local taxes (except sales tax). The net effect to the taxpayer is to receive a subsidy from the federal government for a portion of their local tax liability. Consequently, a portion of local taxes is borne by the nation's taxpayers in general.

Eliminating the deductibility of state and local taxes greatly reduces the ability of tax policymakers to "export" the burden of local taxes to a larger population. Reasonable minds may differ over whether exportability is a good idea from a policy point of view. Where "local" improvements and infrastructure are technically made by a municipality, but benefit an entire metropolitan region, the case for exportation is quite strong. On the other hand, if there are no positive externalities of a locally debt-financed project, the argument for exportation is much weaker. One could, however, make the case that inner cities which serve as commercial and cultural hubs, but

74. Whether this subsidy is efficient is a debatable question, but it probably is not. See Louis Kaplow, Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax, 82 Va. L. Rev. 413, 492 (1996) (concluding that arguments in favor of deductibility of state and local taxes are not as strong as the contention that the benefits of local government equal the costs imposed through local taxes, but finding ultimate policy decision about the wisdom of the deduction difficult and more likely to be decided by political than economic considerations).

75. State and local governments might still "export" a portion of their tax burden by imposing taxes or user fees on activities that are likely to be paid by non-residents, such as a hotel room occupancy tax. See Robert D. Ebel, Comment on Tax Exporting Federal Deductibility and State Tax Structure,” 12 J. of Pol'y Analysis and MGMT. 127, 128-9 (1993) (discussing direct and indirect methods of exportation outside of federal deductibility).

76. See Pechman, supra note 19, at 295-97 (making the argument for exporting municipal finance costs on the grounds that inner-city infrastructure has positive externalities and that the cities themselves may lack the resources to finance the improvements).

77. See, Daniel Shaviro, Federalism in Taxation: The Case for Greater Uniformity 80-81 (1993) ("Without positive externalities from a jurisdiction's providing public goods, tax exportation is clearly inconsistent with fiscal federalism.").
which may not have a large population, and rural areas that require a certain amount of infrastructure, but lack the critical mass of taxpayers to make such expenditures affordable, are good candidates for appropriate exportation, merely because the nation has an interest in maintaining a national infrastructure of government services like airports, education, and police. This is so even if particular pockets of the country cannot feasibly finance the required improvements on the taxpayer base under their jurisdiction.

In any event, eliminating deductibility of state and local taxes from a flattened income tax, or rendering such an adjustment irrelevant by enacting one of the other proposals, will have the effect of increasing the "tax price" of state and local services. This sticker shock will undoubtedly have major political consequences for state and local governments.

Areas of the country where local governments rely more heavily on property and income taxes than on sales taxes and user fees will be affected more dramatically. One factor that influences the imposition of taxes as opposed to user fees under the current scheme of taxation is the availability of the federal tax deduction as a way to ameliorate the effect of local taxes. The elimination of that device could result in the imposition of more user fees as states and localities move away from an ability to pay standard toward a fee for services approach to public finance.

E. Other Effects on State and Local Governments

It is, of course, impossible to estimate with precision all of the effects a fundamental change in federal tax policy will have on any aspect of our economy. The four issues discussed above are likely to be the biggest problem areas for state and local governments, but it is by no means an exhaustive list. For example, the possibility exists that under the sales tax proposals, state and local governments might not be exempt from taxation and would also be liable for taxes on the wages of their employees. Although this and other effects may pose serious problems for state and local governments, they will not be discussed here.


79. See infra notes 203-05 and accompanying text.

80. See Capozza et al., supra note 59, at 191-92 (concluding that the adverse impact of the elimination of property tax deductibility will be greatest in the Northeast and lightest in the South).

81. See Holtz-Eakin, supra note 41, at 120-22 (describing the effects of the proposals).
III. GOALS OF TAX POLICY

Traditionally, the rhetoric of tax policy requires that tax proposals be justified in terms of several key criteria—equity, efficiency, simplicity, and stability. In a perfect world, tax revenues should be collected as fairly as possible, produce as little unintended distortion in the economy as possible, be as simple to administer, comply with, and understand as possible, and be predictable and reliable enough to allow both the public and private sectors to make long run economic plans. These goals are easier to state than they are to achieve.

A. Equity

Discussions of “equity” in tax policy generally break the concept into categories of “horizontal equity” and “vertical equity.” The tax reform proposals under consideration will have a major effect on both of these ideas.

1. Horizontal Equity

A common theme in American tax policy has been that individuals with equal ability to pay taxes should pay the same amount of tax. A tax system which possesses this quality is said to possess horizontal equity.82 Under our present tax system, the principle of horizontal equity is sometimes violated. In some cases, individuals in similar circumstances bear different tax burdens because some forms of income are exempt from tax while others are taxed at favorable rates.83

Under an income tax, horizontal equity is primarily a function of how comprehensively taxable income is defined. If “income” from all sources is taxed (and taxed at the same rate) then horizontal equity would be achieved. In this regard, the flattened tax proposal advances the goal of horizontal equity, but the other plans do not. The tax reform proposals discussed in this Article purport to increase equity in the tax system, but the new base definitions open new areas of horizontal inequity. The most obvious problem is that in the attempt to bolster savings and investment by making interest and

82. See Eric M. Zolt, The Uneasy Case For Uniform Taxation, 16 VA. TAX REV. 39, 87-88 (1996) (discussing the concept of horizontal equity and differences of opinion about how it should be defined).

83. For example, if Taxpayer A receives his income from wages and Taxpayer B receives her income from capital gains and interest on municipal bonds, then Taxpayer A pays a significantly higher tax because capital gains and municipal bond interest income are given a tax break under current law.
dividend income tax exempt, the reforms would not eliminate problems of horizontal equity, but would merely reconfigure them. 84

2. Vertical Equity

While horizontal equity seeks equal treatment of individuals in similar economic positions, vertical equity seeks to ensure that individuals with greater ability to pay tax do in fact pay more tax. 85 Not all participants in the tax debate embrace the idea of vertical equity, as it seems linked in many minds with income redistribution and party politics. 86 Where horizontal equity is concerned more with the tax base, vertical equity is concerned with the tax rate structure. 87 While the tax rate levied in a tax system is a function of

84. See Eisner, supra note 59, at 44 (noting that "the flat tax substitutes serious new distortions for those it would eliminate").

85. See Nancy C. Staudt, The Hidden Costs of the Progressivity Debate, 50 VAND. L. REV. 919, 933-58 (1997) (providing an exhaustive discussion of the concept of vertical equity from several theoretical points of view). One commonly offered justification for progressive income taxation is based on the idea of the declining marginal utility of income. Id. at 941-45. Progressive taxes assume the declining marginal utility of income. Id. From this theory it follows that the 100,000th dollar of income to a wealthy person has a lower marginal utility than the 100th dollar of income to a poor person. Id. Relatively speaking, a wealthy person's dollars are worth less than a poor person's, and so wealthy people should pay more taxes as a portion of their income than poor people do. Id. Conversely, one might think that paying taxes hurts less as wealth increases. Id.; see also Vada Waters Lindsey, The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity, 5 FLA. TAX REV. 1, 8 (2001) (arguing that "any definition of fairness must incorporate the ability to pay concept"). Flat tax advocates vehemently disagree with the declining marginal utility theory of money and find it an unconvincing justification for progressivity. See WALTER J. BLUM & HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION 56-63 (1953) (making the argument against the declining marginal utility of money). For a fine collection of essays surveying the topic of taxing the rich, see DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH (Joel B. Slemrod ed., 2000).

86. The Earned Income Tax Credit has been a battleground for the fairness issue for some time. See Shailagh Murray, Tax 'Fairness' Feud Rages On, WALL ST. J., June 11, 2003, at A4. The rhetoric accompanying this fight belies the class warfare lurking just below its surface. In a regrettable editorial entitled The Non-Taxpaying Class, the Wall Street Journal labeled as "lucky duckies" those taxpayers whose income was so low after adjustments and tax credits that they owed no federal income tax. Editorial, The Non-Taxpaying Class, WALL ST. J., Nov. 20, 2002, at A20. Shortly thereafter, Paul Krugman in the New York Times, took the Journal to task for having the audacity to consider the hypothetical taxpayer earning $12,000 to be a "lucky duck." The Journal had focused solely on federal income taxes and had ignored the fact that this low-income earner had paid about 20% of his income in payroll taxes. Paul Krugman, Hey, Lucky Duckies!, N.Y. TIMES, Dec. 3, 2002, at A31.

87. There are basically three ways a rate structure could be established: progressively, where the ratio of tax liability to tax base increases as tax base increases; proportionally, where the tax liability to tax base ratio is constant as tax base increases; and regressively, where tax liability to tax base ratio decreases as tax base increases. See generally RONALD C. FISHER, STATE AND LOCAL PUBLIC FINANCE
revenue needs and tax base capacity, the tax rate structure is a value judgment on the part of policy makers informed more by philosophy than by economics. Progressivity has been incorporated into the federal income tax since the original act in 1913. Of course, progressive tax rates are not the only option available. True flat tax proposals are proportional in nature, while the VAT and sales tax proposals are likely to have a regressive tax incidence.

In other words, vertical equity says that an individual with a larger income should pay an appropriate amount more in taxes than an individual with a smaller income. Vertical equity is a more subjective concept than horizontal equity, since it involves the comparison of ability to pay between taxpayers with different amounts of resources. Consequently, no one notion of vertical equity enjoys universal support. Flat tax proponents claim to support the idea of vertical equity by focusing not on the percentage of tax paid, but on the overall tax burden toward proportionality and away from regressivity. Horizontal equity is the embodiment of one of the two (sometimes competing) general guiding principles in tax incidence—ability to pay versus payment for benefit received. See Paul Samuelson, Economic Role of Government: Federal Taxation and Local Finance, in Economics 163, 164-65 (10th ed. 1976), reprinted in Policy Readings in Individual Taxation 2, 3 (Philip F. Postlewaite ed., 1980) (noting the general guiding principles of tax policy—taxes should be paid by those who enjoy the benefit from the publicly provided goods and services and people should be taxed in a way that the burden is spread out as equitably as possible and everyone bears an appropriate level of sacrifice).


89. See Bank, supra note 3, at 397 (noting that the 1913 income tax instituted "mildly progressive income tax rates" but moved the overall tax burden toward proportionality and away from regressivity).

90. See John F. Coverdale, Comment, The Flat Tax is Not a Fair Tax, 20 Seton Hall Legis. J. 285, 288-89 (1996) (criticizing flat tax claims of fairness on the grounds that it is not fair to tax everyone at the same rate due to the decreasing marginal utility of money).


92. See Hall & Rabushka, supra note 15, at 28 (criticizing the idea of vertical equity as an intellectual construct invented by "politicians and intellectuals" to justify redistribution of income to attain egalitarian social goals at the expense of "individual freedom and self-reliance"); Robert P. Strauss, The Effects of a Flat Federal Consumption Tax on the States, 88 Nat'l Tax Ass'n Proc. 10, 13 (1995) ("The 'proper' degree of vertical equity achieved through progressivity is typically described as a value judgment, which honorable people can disagree about and which we expect the political process to adjudicate.").
but rather on the differences in the absolute dollar amount of taxes paid. In their view, the rich pay more than the less affluent in absolute dollar terms and that should satisfy concerns about vertical equity.

Part of the difficulty of assessing the federal taxation scheme on the grounds of vertical equity stems from a failure to agree on exactly what should be considered in the tax burden when assessing progressivity, proportionality, and regressivity. In our present tax system, studies have historically shown that the federal income tax has some degree of progressivity, but when combined with state and local levels of taxation the aggregate tax burden is roughly proportional.94 State and local taxes such as sales and property taxes, are notoriously regressive, but their regressive aspect is balanced out by the progressivity of the federal income tax. If the primary federal tax were shifted to a less progressive structure, a proportional structure, or even a regressive structure, the over-all tax burden would be skewed toward regressivity.95

Therefore, from the equity perspective, a flat rate tax would preserve horizontal equity, as would the VAT and the sales tax, but the USA or Armey proposals would not, since taxpayers in similar situations will not be treated similarly. As far as vertical equity is concerned, however, adoption of any of the tax reform plans would require a redefinition of that concept as it has been traditionally understood.

94. See DON FULLERTON & DIANE LIM ROGERS, WHO BEARS THE LIFETIME TAX BURDEN? 5-6 (1993) (building on the tradition of earlier studies and concluding that income tax, even after 1986 changes, remains progressive, even over a lifetime, whereas sales and excise taxes are regressive, and taxes on capital, while progressive, affect wealthy and poor more than middle income over a lifetime); JOSEPH A. PECHMAN, WHO PAID THE TAXES, 1966-1985? 10 (1985) (concluding that, depending on the assumptions employed, the overall tax burden in the United States is either moderately progressive or slightly regressive, and noting that overall progressivity declines from 1966 to 1985 due to the increased importance of the payroll tax); JOSEPH A. PECHMAN & BENJAMIN A. OKNER, WHO BEARS THE TAX BURDEN? 62 (1974) (finding federal tax burden to be clearly progressive and overall burden roughly proportional).

B. Economic Efficiency

Efficiency is often advanced as a goal of tax policy. In practice, the public policy debate carried on under the heading of "efficiency" centers on the idea that taxes should interfere as little as possible with the values of resources in the marketplace. Taxes tend to reduce efficiency in the economy because they distort the price mechanism. The price paid by a consumer will exceed the price received by the seller. Consequently, the imposition of a tax creates a dead weight loss.

Although tax policy should strive to be efficient and not to interfere with market choices, all taxes are inherently inefficient since they invariably affect choices in the marketplace. Sometimes the distortion caused by the imposition of a tax creates an inequity, and policy makers must choose between pursuing the goal of equity or the goal of efficiency. The most obvious cases where equity and efficiency are compromised is in the situation where Congress allows

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96. See Zolt, supra note 82, at 43 (noting that the idea of "efficiency" in the taxation area means "different things to different people"—it could stand for the idea that taxes should interfere in the market as little as possible, or that taxes should attempt to correct market failures, or "it could mean reducing or removing taxes" to bolster economic growth).

97. See Fisher, supra note 87, at 303-04 (defining the concept).


99. These effects can be quite deeply embedded and insidious, as in the way the tax code plays into traditional gender roles. See Anne L. Alstott, Tax Policy and Feminism: Competing Goals and Institutional Choices, 96 Colum. L. Rev. 2001, 2033-36 (1996) (describing the effect of certain aspects of the current income tax, such as joint filing and the level of marginal rates in the context of how those attributes affect women). Some scholars would maintain that the appearance of neutrality is illusory. See Taxing America (Karen B. Brown & Mary Louise Fellows eds., 1996) (providing an anthology of critical tax theory scholarship that points out that, despite the law's claim to objectivity, it has a continuing impact on traditionally subordinated groups along gender, racial, and economic lines). Similarly, when tax law makes contributions to churches tax deductible, it gets into messy choices implicating the First Amendment. See generally Erika King, Tax Exemptions and the Establishment Clause, 49 Syracuse L. Rev. 971 (1999), Randy Lee, When a King Speaks of God; When God Speaks to a King: Faith, Politics, Tax Exempt Status, and the Constitution in the Clinton Administration, 63 Law & Contemp. Probs. 391 (2000).

tax deductions, exemptions, credits, or exclusions. In a situation where a tax expenditure exists, economic efficiency suffers and the tax burden is shifted from those who can take advantage to those who cannot. The intuitive response to the problem created by tax expenditures is to broaden the tax base by eliminating tax preferences.

Relatively high tax rates can create economic inefficiencies as well. Lower tax rates in general reduce inefficiencies, although, in any given situation, it is difficult to determine exactly how economic behavior will change in response to a given change in tax law. Proponents of radical tax reform often make the case that fundamental change in the tax system is needed in order to boost the very low level of household saving in the United States and thereby help our economy generally. Past experiments with tax-based saving incentives, however, have not had a strong track record in demonstrating the value of tax policy as a tool for stimulating widespread consumer-level savings.

101. For example, it is sometimes thought that high marginal rates are a disincentive to work, but it is not clear how lowering the marginal rates would affect a worker's consumption of leisure. In theoretical terms, the change in tax liability (income effect) and the change in marginal tax rate (substitution effect) would give individuals opposing incentives, one to work more, the other to consume more leisure. A simple example illustrates the predicament. Consider the case of a high-income, self-employed professional who can choose to divide his time between working and vacationing as he pleases. A flat rate tax is imposed and his marginal rate plummets from the current highest rate of 38.6% to, say, 17%, and he receives a tax cut of $20,000. He is faced with a choice: should he work more to take advantage of his higher after-tax wage, or should he use his extra $20,000-plus to finance longer and more extravagant vacations? Analysts generally conclude that these two opposing forces nearly cancel out each other in the general economy, at least in the male labor market. There may be distorting income effects for the female workforce, however, that make a progressive tax more inefficient than a proportional tax. See Jerry A. Hausman, Labor Supply, in How Taxes Affect Economic Behavior 27-83 (Henry J. Aaron & Joseph A. Pechman eds., 1981) (describing the substitution and income effects of a tax on income in a theoretical context). Empirical evidence seems to suggest the relationship between tax rates and hours worked may rest on shaky grounds. See Gene Koretz, How Tax Cuts Affect the Rich, BUS. WK., Oct. 19, 1998, at 18 (describing a study by economists at Johns Hopkins and Purdue that found no increase in work time of highly compensated men after the significant marginal rate cuts of the 1986 Tax Act, probably because they were already working as much as they could already).

102. See, e.g., Bill Archer, Goals of Fundamental Tax Reform, in Frontiers of Tax Reform, supra note 25, at 3, 4.

Another boon to efficiency claimed by proponents of flat taxes would be a reduction in the activity of the underground economy.104 Others counter that such claims are perhaps too optimistic and note that participants in the underground economy will still have incentives to avoid taxes even after a major tax reform.105 Given that much of the underground economy is engaged in illegal activities or results from intentional evasion of the tax system, it seems unlikely that the participants in the underground economy will come clean just because the tax system changes.106 To the extent the underground economy includes people who just do not pay their taxes because they believe the tax system is illegitimate, however, radical reform may result in increased voluntary compliance.107

C. Simplicity.

Simplicity has always been a goal of tax policy,108 but over the years it has proved elusive.109 Even judges and tax professionals can become exasperated by the intricate cross-references and layering of tax provisions.110 Sensing the public's frustration with a complicated
tax code, advocates of major tax reform have used a desire to simplify the law as one of their major rallying cries. Simplicity is desirable in order to minimize the costs of compliance and to preserve the perception of equity. Yet under a legislative scheme of any sophistication, including our current system of income taxation, there are limits on how simple a law can be. Defining a key idea like "income," for example, can be a rather vexing exercise, requiring a voluminous set of regulations to describe eligibility for all of the deductions, exclusions, exemptions, and credits involved in determining the tax base. In a world where scholars argue whether legal rules are determinate, complexity is bound to expand as lawmakers attempt to narrow down the range of possible interpretations for a given rule. Some scholars suggest that complexity is inevitable and ultimately beneficial.

complexity of tax code cross references from a practitioner's point of view); Farley P. Katz, The Infernal Revenue Code, 50 TAX LAW. 617 (1997) (providing a handy compendium of colorful language from court opinions lamenting the damning complexity of income tax provisions); Fowler W. Martin, IRS Workers Can't Answer Tax Questions: Taxpayers Seeking Help Often Received Wrong Advice, WALL ST. J., May 14, 2001, at B7 (reporting on an audit by the Inspector General of the IRS of the Service's 500 Taxpayer Assistance Centers which found that the IRS personnel often gave erroneous advice).

Some observers even suggest that the extremely complicated provisions of the 1997 Tax Act were intentionally made as convoluted as possible in order to build public support for reform. See Mike McNamee, Now That We've Made Taxes More Complex, Let's Simplify Them, BUS. WK., Sept. 1, 1997, at 45; Tom Herman, Tax Report, WALL ST. J., Aug. 20, 1997, at A1.

Scholars have studied the problem of complexity from a number of different angles. See Louis Kaplow, A Model of the Optimal Complexity of Legal Rules, 11 J.L. ECON. & ORG. 150 (1995) (using economic theory to examine the optimal level of complexity in light of costs on actors of dealing with the complexity); see also Eric Kades, The Laws of Complexity and the Complexity of Laws: The Implications of Computational Complexity Theory for the Law, 49 RUTGERS L. REV. 403 (1997) (applying computational complexity theory to legal rules to get a perspective on the complexity of rules as a function of the size of the case they apply to).

For a provocative article about why the definition of "income" matters in the larger debate about radical tax reform, see Eric M. Jensen, The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes," 33 ARIZ. ST. L.J. 1057, 1061 (2001) (noting that the Constitution prohibits the federal government from levying unapportioned direct taxes on the People except in the case permitted by the Sixteenth Amendment—taxes on incomes).

For a general discussion of the interaction among indeterminacy of rules and the complexity and fairness of the tax system, see John A. Miller, Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation, 68 WASH. L. REV. 1 (1993). That is not to say that precise rules are always the best rules;
Nevertheless, critics of the current system frequently make rhetorical use of the physical size of the collected tax-related legislation, regulation, instructions, and guidance, as if the sheer volume of the material is what makes the tax law complicated. Yet somewhat counterintuitively, the large volume of tax-related legal material may actually make taxes simpler. Conventional wisdom also holds that more complex provisions promote the goal of fairness by allowing the law to be tailored to fit specific family situations. The policy decision of trading off simplicity for fairness is in the end a normative decision informed by individual values. Some amount of complexity seems inevitable in order to attain an acceptable level of accuracy in measuring the tax base. Conservatives would generally find that the fine tuning is not worth the cost of the complexity.

depending on the goals of the given regulatory scheme, vague rules may serve better. See David A. Weisbach, Line Drawing, Doctrine, and Efficiency in the Tax Law, 84 CORNELL L. REV. 1627 (1999); see also Nicholas L. Georgakopoulos, The Vagueness of Limits and the Desired Distribution of Conducts, 32 CONN. L. REV. 451 (2000).

116. See, e.g., Samuel A. Donaldson, The Easy Case Against Tax Simplification, 22 VA. TAX REV. 645, 650-53 (2003) (arguing that (1) complexity is "either inevitable or net beneficial" in that it is a tradeoff for achieving goals of equity or efficiency; (2) the alleged harms from complexity are anecdotal, at best; (3) proposed remedies to complexity are themselves complex or they over-correct the problem; and (4) simplicity itself is nothing special, but should be understood as being an adjunct to the goals of efficiency and equity).

117. Rep. Chabot of Ohio, for instance, has made the point that the tax code is "four times the length of the Bible." 146 CONG. REC. H2128 (daily ed. Apr. 12, 2000).

118. See SLEMROD & BAKIJA, supra note 112, at 130 ("In fact, having a detailed set of rules could make things simpler, to the extent it clears up gray areas in the tax law."); Boris I. Bittker, Tax Reform and Tax Simplification, 29 U. MIAMI L. REV. 1 (1974), reprinted in POLICY READINGS IN INDIVIDUAL TAXATION, supra note 92, at 356 (noting that simple provisions often leave taxpayers to second-guess the IRS or a court about how a provision will be applied, while intricate, even complicated, provisions help taxpayers comply with the law and make safe decisions).

119. See Joel Slemrod, Which Is the Simplest Tax System of Them All?, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, supra note 59, at 355, 380 ("Some complexity buys the capacity to fine-tune tax liability—to 'personalize' it—according to family characteristics.").

120. The alternative minimum tax, a notoriously complicated area of tax law, is an attempt to achieve horizontal equity. Reasonable minds can differ over whether the gains in equity are worth the added complexity. See Shailagh Murray, Firestorm Looms on Minimum Tax, WALL ST. J., July 1, 2003, at A4.

121. See Louis Kaplow, Accuracy, Complexity, and the Income Tax, 14 J.L. ECON. & Org. 61, 61 (1998) (examining the trade-off between accuracy and complexity, taking into account compliance costs and the provision of appropriate incentives for taxpayers to acquire the information necessary to comply with the law).

122. See RICHARD A. EPSTEIN, SIMPLE RULES FOR A COMPLEX WORLD 39 (1995). Epstein states:

The only question for the legal system is how it will make its errors, not whether it will make them. Simple rules are adopted by people who acknowledge that possibility of error up front, and then seek to minimize it
Philosophical issues of complexity aside, however, as a practical matter, for most taxpayers the portion of the current law that applies to their situation is not all that complex. The Internal Revenue Service has made great strides to simplify taxpayer filing with streamlined forms, detailed instructions, and simple tax tables. In 2000, approximately 40% of all taxpayers filed one of the abbreviated forms. Despite the incredibly simple directions and requirements for filling out these simple forms, however, over 4.4% of the form 1040EZ filers and over 14.5% of the form 1040A filers submitted returns that included a paid preparer's signature. The need for professional assistance could be the result of a complex tax code, but the forms at issue here are truly simple. A better explanation is that most taxpayers have a very modest complexity horizon when it comes to taxation issues. That many Americans find their taxes complicated should come as no surprise in light of the terrifyingly high number of Americans who have trouble reading a bus in practice. Complex rules are for those who have an unattainable vision of perfection.

Id.

123. See SLEMROD & BAKIJA, supra note 112, at 130 (suggesting that most taxpayers do not spend much time on their taxes).
124. See INTERNAL REVENUE SERV., 22 SOI BULLETIN 153 (Winter 2002-2003) (providing table with data on individual returns showing that, of the 129,373,500 total returns filed in 2000, 28,826,589 were made on form 1040A and 21,700,809 were made on form 1040EZ).
125. Id. at 153, 194 (providing data on returns filed in 2000 by type of form and number of returns that included a paid preparer's signature).
126. Although there is scant data to verify the trend, the high number of paid preparers on simple returns might be evidence that many low-income taxpayers are availing themselves of tax refund lending schemes offered by paid preparers.
127. See JOHN ALLEN PAULOS, A MATHEMATICIAN READS THE NEWSPAPER 120-25 (1995) (discussing the idea of a complexity horizon). Paulos defines the complexity horizon as being the limit of a person's comprehension beyond which "social laws, events, and regularities are so complex as to be unfathomable, seemingly random. Applied loosely and casually, the term is useful in referring to discriminations that are impossibly subtle for a given group of people at a given point in time." Id. at 120.
128. Consider, for example, that the General Accounting Office found that about 510,000 federal income tax filers in 1998 elected the standard deduction instead of itemizing their deductions, even though they had mortgage interest deductions that exceeded the standard deduction. The average overpayment amount was $610. See UNITED STATES GENERAL ACCOUNTING OFFICE, REP. NO. GAO-01-529, TAX DEDUCTIONS: ESTIMATES OF TAXPAYERS WHO MAY HAVE OVERPAID FEDERAL TAXES BY NOT ITEMIZING 2 (2001), available at http://www.gao.gov.
129. In a recent poll conducted by the Kennedy School of Government at Harvard together with NPR and the Kaiser Family Foundation, eighty-seven percent of respondents considered the current federal income tax system to be either "very complex" or "somewhat complex." National Public Radio/Kaiser Family Foundation/Kennedy School of Government, National Survey of Americans' Views on Taxes (April 26, 2003), at http://www.npr.org/news/specials/polls/taxes2003/index.html.
It is somewhat surprising that more filers do not require assistance.

Nevertheless, even if the complexity argument does not fit the facts as well as its proponents would like it to, a simpler system might cost less to comply with. The cost of tax compliance includes the costs of tax record keeping, reporting, and planning along with more subtle societal costs. Administration of and compliance with the tax code can be costly and time consuming. In addition to the costs of compliance, unnecessary complexity eats away at taxpayer respect for, and voluntary compliance with, the tax law. Complexity can affect horizontal equity because similarly situated taxpayers may pay different amounts of tax because they do not share the same ability to understand the law or get professional tax counseling. Taxpayers may suspect that complexity is a cover for some to pay less than others; and this could mean that taxpayers lose faith in the equity of the tax system. Indeed, it has been suggested that

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130. In a startling study by the Department of Education in conjunction with the Educational Testing Service, more than 26,000 American adults were tested on practical, every-day matters such as reading newspaper articles, filling in simple forms, and answering questions involving basic math skills. The test's results were categorized into five levels of competence. Extrapolating from the test results, approximately forty to forty-four million Americans perform at the lowest level, meaning they are unable to calculate the total of a purchase, determine the difference in price between two items, read a street map, or enter information on a simple form. It also indicates that an additional fifty million perform at the second-lowest level: they are unable to answer specific questions about facts in a newspaper article or to interpret charts summarizing information. With regard to the rest of the competence levels, the test found that sixty million Americans function with middle-level skills, and thirty-four to forty million function at the two highest levels. IRWIN S. KIRSCH ET AL., ADULT LITERACY IN AMERICA xiii-xv (1993); see Tamara Henry, College-Level Literacy “Less Than Impressive,” USA TODAY, Dec. 12, 1994, at A1 (reporting the results of an Educational Testing Service study of college-educated adults that found, among other things, that about half of four-year college educated adults could not read a bus schedule).

131. The IRS reports that many errors found on tax returns have nothing to do with the complexity of the tax law but are instead the result of sloppiness or poor reading and arithmetic skills. Karen Hube, IRS Has a Gripe Too: Sloppy Taxpayers, WALL ST. J., May 13, 1999, at C1.


lawmakers prefer a complex tax code because intricate provisions allow them to raise taxes on some groups and lower taxes on other groups without political accountability.134

Proponents of flat rate taxes portray them as the ultimate in tax simplification.135 While it is likely that the elimination of certain tax expenditures and some other aspects of the new proposals will result in some simplification, similar simplicity gains could be achieved through reform of the existing tax scheme.136 Enactment of the new tax plans would bring new complexity problems. For example, by taxing income that is now exempt, tax compliance will become more complicated. Paying taxes on the interest from municipal bonds as contemplated under the flattened tax proposal would entail a whole new layer of bureaucracy at the federal level to keep track of bond issues and to make sure they are reported. The simplicity gains under the flattened tax from switching to an exemption-free tax base would in all likelihood be offset, if not outweighed, by administrative headaches of keeping track of the newly taxable aspects of the broadened tax base, such as the interest on municipal bonds.

The claim by some that tax returns would be simplified enough to fit on a postcard is without a doubt exaggerated.137 The space on the current return for taxpayer's name, address and other clerical information exceeds the area of a five inch by eight inch postcard. A flat tax would not eliminate the need for this information. While repeal of tax expenditures would eliminate some lines, the inclusion of new types of income would add lines. Much of the information required on the forms is there so the IRS can check compliance without a full-scale audit. Elimination of items such as dividend and

tax preferences and tax shelters created the impression that the tax system was unfair and that the 1986 Tax Act's curtailment of tax preferences and tough anti-shelter provisions "were crucial for improving the perception of fairness").

135. See, e.g., Charles E. McLure, Jr., The Simplicity of the Flat Tax: Is It Unique?, 14 AM. J. TAX POL’Y 283 (1997) (describing the simplifying aspects of the Hall/Rabushka style of flat taxes and a brief summary of the other proposals and contrasting them with the limits of simplification under traditional income tax reform).
136. See, e.g., Martin J. McMahon, Jr., Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fund for Itself, 50 WASH. & LEE L. REV. 459 (1993) (proposing changes to the existing tax code that would simplify its application); Joseph A. Snoe, Tax Simplification and Fairness: Four Proposals for Fundamental Tax Reform, 60 ALB. L. REV. 61 (1996) (detailing four specific reform programs within the context of the existing income tax that could have dramatic simplification gains for the system).
137. For a humorous take on what that postcard-sized return might look like, see Bruce McCall, Flat Tax Return, THE NEW YORKER, April 8, 1996, at 110.
interest income would make tax enforcement more costly and would represent a gain for simplicity at a cost for efficiency.

Finally, the transition from our present tax scheme to a new regime will not be simple. No matter how “simple” a new tax regime may appear in the abstract, we must keep in mind that it will be interpreted by fallible judges who sometimes get confused or add complexities of their own. Indeed, the now-maligned income tax code started out just fourteen pages long and its application was profoundly shaped by judicial decisions applying that “simple” statute to devilishly detailed practical situations. The concepts developed under the income tax code are likely to continue to guide judicial interpretations of any new tax plans because all of the reform proposals make extensive use of well-established tax terms rooted in the distinctions arising under present law.

D. Stability

A sudden, drastic change in the tax base and tax rates would wreak havoc in all areas of the economy, and especially in the state and local government sector. The tax code is currently a major consideration for all actors in the economy, be they investors deciding what to invest in, or local government finance officers deciding whether to borrow or tax to fund a particular project. Given that virtually all actors in the economy base their decisions at least partly on tax considerations, many people will be hurt economically if the tax treatment of their actions changes suddenly.

138. See generally Mary L. Heen, Plain Meaning, the Tax Code, and Doctrinal Incoherence, 48 HASTINGS L.J. 771 (1997) (discussing the challenges of coherent and consistent judicial interpretation of statutory provisions using tax decisions involving the same statutory provision interpreted with three different techniques).

139. See Pollack, supra note 132, at 322-330 (providing a concise history of the income tax code from its inception through World War I).

140. See Lester B. Snyder and Marianne Gallegos, Redefining the Role of the Federal Income Tax: Taking the Tax Law “Private” Through the Flat Tax and Other Consumption Taxes, 13 AM. J. TAX POL’Y 1, 4-5 (1996) (“Much of what has been written to date on the proposed consumption tax legislation presumes Congress will be writing on a clean slate. However, many of the concepts referred to in the consumption tax bills borrow heavily from current income tax law.... By retaining these distinctions in the proposed reforms, we create a new generation of complexity...”).

141. See Christopher Farrell, A Flat Tax is Flat-Out Risky, BUS. WK., Feb. 19, 1996, at 80 (“The gains could be easily dwarfed by wrenching business and household upheavals as America shifts to a new tax code.”).

142. For example, the value of tax exempt obligations decreases based on changes in the tax law, affecting the net worth of the holders of those obligations. For a more complete discussion of transition dislocations, see generally Ronald A. Pearlman, Transition Issues in Moving to a Consumption Tax: A Tax Lawyer’s Perspective, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, supra note 59, at 393, 406, discussing major transition problems such as the fairness to taxpayers nearing
There has been a spirited debate in academic circles concerning whether there is a need for transition rules to soften the blow to taxpayers who made plans under one tax regime only to have those plans significantly altered by subsequent tax law changes. In the view of some scholars, such transition rules are economically wasteful since they amount to insurance policies protecting vested taxpayers against the repeal of tax preferences. Because these insurance policies are funded by the public, the beneficiaries of the insurance have no incentive to respond to changing political and economic realities. Others have argued that forsaking transition rules will only make the situation worse by increasing political maneuvering and increasing the cost of tax preferences to the government to compensate beneficiaries for the lack of grandfathering protection. It may be that the transition rules are irrelevant as a matter of economics or finance and that the real test for transitional relief is a political one. One thing is certain: if the current tax scheme is repealed, the groups that benefited from that system will “clamor for political relief.”

Regardless of the outcome of the debate about what to do when the tax law changes, it nevertheless remains true that, all things being equal, stability ordinarily is a goal of tax policy. Although there have been many changes to the income tax code over the years, the changes have occurred within the context of a familiar system.

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145. See Eric Chason, The Economic Ambiguity (and Possible Irrelevance) of Tax Transition Rules, 22 VA. TAX REV. 615, 618 (2003) (setting forth the case that the choice of tax-transition rules is “generally irrelevant from an efficiency or revenue perspective”).

146. See Julie Roin, The Consequences of Undoing the Federal Income Tax, 70 U. CHI. L. REV. 319, 321 (2003) (describing some of the political battles that may be anticipated if the income tax is repealed).
Wholesale reform of the entire taxation system has no modern precedent in the United States. It would be very difficult to predict the disruption that the transition would engender, but even supporters of flat tax plans admit there would be significant instability during the transition.\(^{147}\) Even after the transition, however, the new flat taxes would be subject to tinkering the same way income taxes currently are. It will be hard to realize any benefits from any plan if the taxation scheme is not left in place long enough for the changes brought about by the new regime to take root.\(^{148}\)

The current tax code already changes with fair regularity, and we should expect a new tax code to require some fine-tuning that will result in technical changes for a few years after enactment. Given the fundamental nature of the reforms being proposed, it is unlikely that policy makers will get all the details of the new tax regime right on the first try. Even without technical adjustments, it is merely the nature of our political process that Congress will be unable to resist the temptation to tinker with the tax code regardless of the tax base.\(^{149}\)

Besides the importance of stable tax policy to investment planning, the tax system should act as a stabilizing influence on the economy during times of economic fluctuation. In the economy at large, the income tax structure is responsible for countering swings in the business cycle. In an upturn of the economy, caused by either real economic growth or inflation, the income tax automatically produces higher revenue yields without lag time or a governmental discretionary act, such as a reassessment of property, and collects less in a downturn number. In this way, the government extracts more money during times of prosperity and less in recessionary times to lessen the possibility of the economy swinging out of control.\(^{150}\) A consumption tax is less likely to be as robust an automatic stabilizer because the revenue stream produced by the tax will be much "more stable over the business cycle."\(^{151}\)

\(^{147}\) See McLure, supra note 135, at 294 ("[T]ransition from the current income tax to the flat tax would inevitably be complicated.").

\(^{148}\) See The Flat Tax: "Nutt" It's Not, WALL ST. J., Feb. 22, 1996, at A14 (Gary Becker opining that the long term benefits of a flat tax will not be achieved unless the tax structure is stable over time).

\(^{149}\) See Nolan, supra note 8, at 219 (voicing the opinion that Congress will inevitably tinker with and experiment with the tax system to meet various economic, social, or other goals).

\(^{150}\) See PECHMAN, supra note 19, at 9-20 (discussing the automatic stabilization effect of the income tax).

This attribute of cycle-countering causes the revenue yields of
the income tax to be quite volatile. While it lends stability to the
economy in general, the volatile yields of the progressive tax make
fiscal planning in the public sector a more difficult task. The revenue
yield from the Hall/Rabushka inspired reform proposals potentially
will be much more reliable and will have the benefit of making fiscal
planning easier, even if its macroeconomic stabilizing effect is less.

The preceding discussion shows that the tax reform proposals
would fail to achieve the traditional goals of tax policy. If the
negative impact on municipal finance that would result from
adoption of the reform proposals is as obvious as it seems, then the
proponents are either willfully blind to the problems their bills could
create or they are in fact promoting these proposals for reasons other
than the attainment of the traditional tax policy goals. An
alternative explanation for promoting radical tax reform may be
found in the political philosophy of conservatism.

IV. AN ALTERNATIVE EXPLANATION FOR RADICAL TAX REFORM

As the preceding discussion points out, enactment of any of the
radical tax reform proposals will fail to achieve the policy goals of
vertical equity, efficiency, or stability and will generate adverse
consequences that will outweigh the modest gains to horizontal
equity and simplicity that might result from their enactment. This
policy failure seems fairly likely when examined in light of the
traditional goals of tax policy, yet the sponsors of radical tax reform
continue to promote their plans in the language of fairness,
simplicity, efficiency, and stability. When the rhetoric of reform and
the predictable consequences of the proposals do not add up, one
must wonder if the proponents truly believe what they are saying or
whether there is something else going on. If one looks at the political
ideology of the proponents of radical tax reform, one sees that
something else is going on. Flat tax proponents are really concerned
about one of the most fundamental issues of our political system—the
power of the central government.

The proponents of radical tax reform are politicians who would
likely describe themselves as "conservative" even though they
certainly are not all cut from the same cloth. The rise of
conservatism has been a major force in American politics in the past

152. See id. at 15.
153. See Kornhauser, supra note 9, at 2348 (discussing the rhetoric of the tax
reform debate: "Behind the economic arguments, however, lurk beliefs about the
extent and nature of government, the right to property, and moral worth.").
154. Representative Gephardt is the exception that proves the rule. He is certainly
more "liberal" than the other would-be tax reformers.
twenty years, although exactly what conservatism is remains hard to define with precision. Given all of the internal contradictions and differences of opinion among political actors who refer to themselves or are classified by others as "conservative," it would probably be incorrect to refer to American conservatism as an "ideology."

Nevertheless, there are several core beliefs in the conservative tradition, and, by urging the implementation of sweeping changes in federal tax law, conservative legislators are seeking to advance two important conservative goals: (1) elimination of the opportunity for the federal government to engage in what they consider to be illegitimate "social engineering" through the use of tax expenditures contained in the tax code; and (2) changing the way taxes are raised in order to make the total tax burden more visible to state and local taxpayers in hopes that the citizens will rebel against taxes generally and reduce the taxes over which they have the most control. The traditional tax policy goals discussed earlier in this Article are only window dressing for these real objectives.

One might fairly respond, however, that the distinction between the putative goals of tax policy (i.e., efficiency, equity, simplicity, and stability) and the two real goals (reduction of social engineering and a devolution of taxes to the local level) may not be such an airtight distinction. One might maintain that the putative and the real goals are more intimately intertwined than suggested and indeed are means to one another, or are sub-species of one another. For

155. Exactly what constitutes a conservative has been the subject of much debate. See SARA DIAMOND, ROADS TO DOMINION: RIGHT-WING MOVEMENTS AND POLITICAL POWER IN THE UNITED STATES 9-11 (1995) (identifying four broad movements that are often referred to as being part of the "Right": (1) the anticommunists, (2) the racist Right, (3) the Christian Right, and (4) the neoconservatives); CHARLES W. DUNN & J. DAVID WOODARD, THE CONSERVATIVE TRADITION IN AMERICA 28-42 (1996) (noting the lack of agreement on whether conservatism is an ideology and summarizing the views of five political philosophers who have attempted to characterize the different types of contemporary American conservatives). Often libertarians are lumped into the "conservative" category, although there is certainly much tension between true libertarians and other brands of conservatism such as, say, moral/religious conservatives. For example, it is likely that libertarians would oppose "social engineering" as an illegitimate infringement of individual freedom in all situations, whereas moral conservatives might not mind social engineering if it promotes a set of behaviors in which they believe, while neoconservatives might merely be wary of it, one way or another. See generally E.J. DIONNE, JR., WHY AMERICANS HATE POLITICS (1991).

156. Of course, it is not that unusual for politicians to be less than completely candid about what they hope their legislation will achieve. It is not uncommon for legislation to be justified in language that has wide acceptance because stating its true purpose in plain language would fail to attract the political support necessary for passage. See Eric J. Gouvin, Truth in Savings and the Failure of Legislative Methodology, 62 U. CIN. L. REV. 1281, 1327-34 (1994) (discussing the common lack of candor in the legislative process and providing examples).
example, a conservative could take the position that, while efficiency is a value maximized by non-interference with the market, what motivates defenders of efficiency is the belief that individuals should make their own choices, and the field of choices should be as expansive as possible. Taxes interfere with efficiency because they create obstacles to offering certain products and services that, in turn, reduce individual choice. It is a small step to argue that the general objection to social engineering is cut from the same cloth. What conservatives object to about social engineering is that the social and political landscape is being altered from above and in a way (1) that may not reflect the policy choices of the people, and (2) which, once implemented, narrows the range, or raises the costs, of available choices. In the end, the conservative argument could be summed up by saying that the policy imperative for tax efficiency and the conservative antipathy to federal social engineering are two different aspects of the conservative belief in the importance of individual choice.

Such an argument makes sense in the abstract, but, as applied to the flat tax debate, it falls a bit short. While the four traditional goals of tax policy get their due in public discussions of radical tax reform, the opposition to "social engineering" or the promotion of devolution is not rolled into the discussion of "efficiency." The efficiency discussion focuses on economics and economic efficiency rather than on the political values of liberty and personal choice. The two "real" motivations developed in this Article, while they might be thought of as subsets of other aspects of conservative thought, are usually not discussed as such in the public debate and, in fact, are often omitted from or downplayed in the policy discussion. This section will examine the "real" goals in more detail.

A. Eliminating the Use of Tax Expenditures for "Social Engineering"

Although conservatism is by no means a uniform ideology, there are some core foundation principles to which most conservatives subscribe, including the following: (1) conservatism is more of a world view than a political agenda; (2) conservatism does not embrace the notion of "the perfectibility of man" or the attainment of a social utopia and offers no prescriptive program to solve social problems; and (3) conservatives believe that change should proceed gradually and organically within the bounds of existing local institutions, such as communities, churches, universities, and organizations rather than through the agency of central government imposing
Conservatives harbor a deep suspicion of intellectual fashions. They are much more likely to perceive the time-tested societal traditions and customs as preferable to radical new ideas. This bias in favor of established institutions arises because, in the conservative worldview, the intellectual capacity of any one human being is relatively slight compared to the sum total of human experience over the ages. Skepticism of human omniscience brings with it a skepticism of governmental omniscience because governments are composed of human beings and all human beings have a limited stock of reason and wisdom. Because they are skeptical of the capabilities of government to do a better job in directing human behavior than the organically evolved social norms and institutions handed down from history, conservatives oppose attempts by the central government to engage in "social planning." That conservatives distrust government sponsored programs calculated by policy analysts to bring about socially beneficial change should not be interpreted to mean that conservatives are opposed to all change whatsoever. Change is inevitable and even necessary if a society is to survive and thrive. Conservatives, however, prefer to see that inevitable change proceed from experience and be as consistent as possible with tradition, continuity, and social order. Conservatives loath proposed changes to the social order, no matter how well-reasoned or well-intentioned, that spring from the abstract intellectual constructs of social planners rather than from the natural progression of human experience. Indeed, there is a special epithet conservatives employ to describe government efforts to mold human behavior: "social engineering."


158. Id. at 36-37 (quoting Edmund Burke for the proposition that it is better to rely the "general bank of capital of nations and ages" than on the "private stock of reason" of an individual).

159. The modern conservative's distrust of central planning owes a great deal to the work of Friedrich A. Hayek, who warned about the pernicious effects of government involvement in the economy. See generally FRIEDRICH A. HAYEK, THE ROAD TO SERFDOM (1944) (articulating the view that central direction of economic activity according to a government plan ultimately brings dictatorship and the suppression of freedom).

160. CLINTON ROSSITER, CONSERVATISM IN AMERICA 72-76 (1955) (expressing the idea that stability, continuity, and the restriction of change contribute to a good society).

161. KIRK, supra note 157, at 9 (noting a profound distrust by conservatives of "'sophisters, calculators, and economists' who think they can reinvent society according to their own designs).

162. Use of the term "social engineering" has not been limited to conservatives, however. Liberals have co-opted the term to describe the conservatives' pro-family
Try as one might, it is difficult to find the term "social engineering" used in anything but a pejorative sense. It is not, however, difficult to find it used in conjunction with discussions of federal tax policy. It may not be going too far to suggest that conservatives see Adam Smith's invisible hand as being guided by the hand of God acting through the free will of His people. Indeed some people believe their religious convictions compel them to press for fundamental tax reform. When government attempts to pervert the free choices of those people by creating artificial incentives in the tax code that would not otherwise be present in the free market, conservatives take it almost as an affront to human dignity.


164. See Paul Craig Roberts, A Groundswell is Building: Toss the Tax System, BUS. WK., May 5, 1997, at 26 ("The function of a tax system is to raise revenues, not to engineer society."); Sen. John Ashcroft, Tax Relief for Those Most in Need, WALL ST. J., Nov. 13, 1996, at A22 (referring to the Clinton administration as "social engineers" who "tinker with the American peoples' judgment").

165. For an explicit articulation of opposition to tax expenditures on the grounds they violate God's plan, see RONALD PASCUARIELLO, TAX JUSTICE: SOCIAL AND MORAL ASPECTS OF AMERICAN TAX POLICY 2, 5 (1985). In the chapter entitled "Christians and the Tax System," the author notes: "[a] second reason for Christian concern about the tax system is this: Through the tax system, the government encourages certain types of economic and social behavior." Id. at 2. The author goes on to draw the following lesson from scripture:

The lesson of Genesis is this: To be human, to be made in the image of the Creator, is to be endowed with the ability to give shape to the world, to have the ability to participate fully in one's society, to have one's voice heard, to make a difference.... If this is what we are to be, shapers of the economic and social reality of the world, and if indeed this is what the tax system does, then we must be involved with the tax system as a Christian duty. Whatever distortions it contains of essentially Christian values, are the product of our intention or of our indifference. In either case, we have a responsibility[... by virtue of the fact that we are responsible ... to assure that the tax system helps deliver a just, sustainable and participatory world.

Id. at 5.


Although they obviously engender strong opposition on philosophical grounds, tax incentives have long been used as an instrument to induce socially desirable activities in the general economy or to provide tax subsidies or penalties to correct market failures.\textsuperscript{168} Although the public typically refers to these tax incentives as "loopholes," tax policy analysts call them "tax expenditures."\textsuperscript{169} Tax expenditures have been defended on the grounds that they promote employment, economic growth, and equity, support worthwhile institutions, and assist state and local governments.\textsuperscript{170} Proponents also insist that government intervention in the economy is justified when there is a perceived failure of the private market to allocate resources efficiently.\textsuperscript{171} In addition, advocates urge, in some cases, there are advantages to providing subsidies through the income tax instead of providing an explicit subsidy through a government agency because the tax incentive can be administered through the tax system, which is already in place and which reaches virtually all of the American public.

While tax expenditures can be defended on policy grounds, they always entail a trade-off of equity and/or efficiency in the tax system, and sometimes they do not achieve the goals they were designed to address.\textsuperscript{172} There is a large literature criticizing tax expenditures for behavior, or more precisely human happiness and welfare, can be reduced to a mathematical or engineering construct denigrates the wonderful diversity of human beings. . . . There is . . . a demonstrably superior judge to answer all these questions [about allocating resources]: Free markets and free choice. There is also a by-product to free choice in a free market—dignity.”).


\textsuperscript{169}. Tax expenditures are made through the federal individual income tax by way of the exclusion, exemption, or deferral of certain types of income from taxation, a preferential rate on certain types of income, or a deduction or tax credit for certain selected costs. See Nonna A. Noto, \textit{Tax Expenditures: The Link Between Economic Intent and the Distribution of Benefits Among High, Middle, and Low Income Groups}, in 5 STUDIES IN TAXATION, PUBLIC FINANCE AND RELATED SUBJECTS—A COMPRENDIUM 59, 60 (Fund for Public Policy Research ed., 1981) (noting the forms of tax expenditure).

\textsuperscript{170}. Murray L. Weidenbaum, \textit{The Case for Tax Loopholes}, in A NEW TAX STRUCTURE FOR THE UNITED STATES 16, 25 (David H. Skadden ed. 1978) (noting these rationales for tax expenditures).

\textsuperscript{171}. See generally Jane G. Gravelle, \textit{Tax Policy and Spillover Effects: The Use of Tax Provisions to Induce Socially Desirable Activities}, in 5 STUDIES IN TAXATION, PUBLIC FINANCE AND RELATED SUBJECTS—A COMPRENDIUM 50 (Fund for Public Policy Research ed., 1981) (stating that examples of tax expenditures that address market failures or attempt to correct externalities have included pollution control and historic preservation).

\textsuperscript{172}. See Rochelle Sharpe, \textit{Great Expectations: A Tax Credit Designed to Spur Hiring Seems Promising—at First}, WALL ST. J., Aug. 21, 1997, at A1 (reporting on businesses’
a number of shortcomings. In general, however, tax expenditures tend to raise problems with equity and efficiency.

Despite the economic and policy arguments that can and have been made against tax expenditures, when conservative politicians voice their support for tax reform, the case for eliminating tax expenditures boils down to the language of social engineering. A sampling of rhetoric from the Congressional Record bears this out:

> Rep. McCrery, Republican of Louisiana, speaking in favor of broad marginal rate tax cuts:

> [U]nlike the tax policy of the prior [Clinton] administration, marginal rate cuts do not discriminate. They do not favor only individuals engaging in activities deemed worthy. They do not

experience with a tax incentive designed to motivate the hiring of welfare recipients and finding that the red tape of qualifying for the incentive often outweighed the benefit provided).

173. For the classic assault on tax expenditures, see Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 HARV. L. REV. 705 (1970) (attacking tax expenditures on the grounds that they reward taxpayers for doing what they would have done anyway, benefit the wealthy, distort the market, and contribute to high tax rates by eroding the tax base); see also CHRISTOPHER HOWARD, THE HIDDEN WELFARE STATE: TAX EXPENDITURES AND SOCIAL POLICY IN THE UNITED STATES (1997) (arguing that tax expenditures have created a "hidden" welfare state that is more difficult to monitor and control than the one that is administered through direct government programs); MARK KELMAN, STRATEGY OR PRINCIPLE?: THE CHOICE BETWEEN REGULATION AND TAXATION (1999) (raising concerns about political accountability when the tax system is used to regulate behavior instead of the more transparent method of raising money and promulgating legislation).

174. With regard to equity, it is sometimes said that tax expenditures benefit the wealthy at the expense of the poor. Empirical evidence fails to support that idea, however. See Noto, supra note 169, at 61-64. A study examined tax expenditures for the fiscal year 1978 in four broad categories: investment, consumption, employment, and need. Id. at 61. The investments tax expenditure category included items such as the investment tax credit, depreciation, depletion allowances, capital gains benefits, and the exclusion of municipal bonds. Id. at 61-62. The consumption category included deductibility of state-local taxes, charitable contributions, medical expenses, and mortgage interest. Id. at 62. The employment tax expenditure included all untaxed fringe benefits, and the need category encompassed the exclusions of various types of transfer payments and pension allowances. Id. at 62-63. The study found that the benefits were distributed regressively (i.e., the poor got more) in the need category, and progressively in the investment category, but that the consumption and employment categories showed no unified trend. Id. at 61-64.

175. On the efficiency front, some analysts insist that tax expenditures are less efficient than an up-front direct subsidy. Burstein, supra note 100, at 72. The exemption for the interest of municipal bonds from taxation is often cited as an inefficient means of subsidizing state and local borrowing. See id. Reformers suggest that the government should make direct subsidy payments to municipalities. See id. (noting the potential cost savings to the federal government by using a direct subsidy for municipal bonds instead of the current scheme of exclusion from taxation).
use IRS agents as social engineers. Under these marginal rate cuts, if one pays income taxes, one gets a tax cut. It is that simple.\textsuperscript{176}

\begin{itemize}
\item Sen. Mack, Republican of Florida, speaking in favor of reducing the so-called marriage penalty: “It has of late become common practice to use the Tax Code for purposes of social engineering, discouraging some actions with the stick of tax penalties and encouraging others with the carrot of tax preferences.”\textsuperscript{177}
\item Sen. Roberts, Republican of Kansas, speaking against either the income limitations on the $500 per child tax credit contained in the Taxpayer Relief Act of 1997 or against the credit itself: “That is more social engineering than tax policy.”\textsuperscript{178}
\item Then Rep. (now Sen.) Brownback, Republican of Kansas, speaking on the matter of taxes: “It is time we cut back on manipulation out of Washington and say that the Tax Code is not for social engineering; it is not for economic engineering. The Tax Code is for raising revenue for the federal government.”\textsuperscript{179}
\item Sen. Abraham, Republican of Michigan, speaking on the conservative revolution of the 1994 election: “They saw the dangers big-government social engineering posed to our economy and brought about the most significant political revolution in this country in 50 years, putting the free-market Republican party in control of both houses of Congress.”\textsuperscript{180}
\item Rep. Cook, Republican from Utah, speaking on the topic “Our Country Needs Sweeping Tax Reform”:

\begin{quote}
Congress has used the American Tax Code as a tool for social engineering, and that is not right. Behaviors are rewarded or punished through a little tinkering here and a little tinkering there of the Tax Code. I believe that is a cynical and improper use of our power. Americans pay taxes to support a government created to serve them, not to a government created to control them.\textsuperscript{181}
\end{quote}
\end{itemize}

\textsuperscript{176} 147 CONG. REC. H2214 (daily ed. May 16, 2001).
\textsuperscript{177} 146 CONG. REC. S6825 (daily ed. July 14, 2000).
\textsuperscript{178} 143 CONG. REC. S8455 (daily ed. July 31, 1997).
\textsuperscript{179} 142 CONG. REC. H3457 (daily ed. Apr. 16, 1996).
\textsuperscript{180} 144 CONG. REC. S7699 (daily ed. July 8, 1998).
\textsuperscript{181} 143 CONG. REC. H783 (daily ed. Mar. 6, 1997).
Sen. Craig, Republican of Idaho, speaking on the Internal Revenue Service Restructuring and Reform Act of 1998:

The tax laws of our country should not be used for social engineering, nor should they be designed in such a way to tempt and enable legislators and bureaucrats to manipulate social policy in this country, to decide for the taxpayers what is good for them, and to use the tax code and the IRS to force them to behave accordingly. That impulse for social engineering, directed from a Washington, DC, that thought it was all-knowing, is what grew the tax code and gave the IRS its power. Decades of tax-and-spend Congress empowered and encouraged the tax collector to step outside the due process Americans expect in every other encounter with their government, and went about structuring social policy through tax law; and they gained power and they gained control.\(^{182}\)

Sen. Craig, Republican of Idaho, speaking on Tax Reform generally: "The Internal Revenue Code is too complex, produces arbitrary results, and is far too involved in social engineering.\(^{183}\)

Senator Grams, Republican from Minnesota, speaking on the Treasury and General Government Appropriation Act, 1999:

The tax code must be terminated because it has long been used as a tool for social engineering and income redistribution rather than sound economic policy . . . . Clearly, a system of graduated marginal rates violates the principle of fairness. In addition, special interest groups are often unfairly rewarded by politicians with special tax privileges.\(^{184}\)

Sen. Shelby of Alabama, speaking on the introduction of the Freedom and Fairness Restoration Act of 1997: "The current Tax Code is the product of a 40-year experiment with social engineering that has hampered the effort of the American people to be free, bear the fruit of their labor and ultimately live the American dream.\(^{185}\)

\(^{182}\) 144 CONG. REC. S7663 (daily ed. July 8, 1998).
\(^{183}\) 143 CONG. REC. S3196 (daily ed. Apr. 15, 1997).
\(^{185}\) 143 CONG. REC. S7770 (daily ed. July 21, 1997).
Rep. Dick Armey of Texas, on taxation generally: “as a result of decades of social engineering, the United States Tax Code has evolved into a complex maze of deductions, credits, exemptions, and special preferences under which taxpayers with same incomes can pay vastly different amounts in taxes,” and in support of the Flat Tax: “[after the enactment of a flat tax] no longer will the special interests be able to work their political mischief. Nor will the social engineers be able to conduct their experiments in the tax code.”

Rep. Chabot, Republican of Ohio: “To their [liberal Democrats’] way of thinking, only if the government decides whether they are worthy of some social engineering should they get a tax cut.”

Rep. Schaffer, Republican of Colorado: “Of course, April 15 is not a day liberals find too offensive. April 15 is a high holy day for all the social engineers, the central planners, and the big government liberals who worship at the altar of bureaucracy.”

These are not traditional economic arguments about the efficiency of tax expenditures. These arguments do not even pick up the standard rhetoric of tax policy. These are instead political arguments about the acceptable extent of government power. They are informed by the writings of Nobel-prize winning economist Freidrich Hayek, whose distrust of government power ran deep.

These arguments made against social engineering and the evil of tax expenditures are no doubt made in sincerity by public-minded citizens and grounded on deeply-held philosophical beliefs. Yet the proponents of these massive changes seemingly fail to appreciate the irony of their position—they want to throw out one set of socially engineered incentives and replace them with a different set. All of

187. Armey, supra note 104, at 97.
190. See DICK ARMEY, THE FLAT TAX: A CITIZEN’S GUIDE TO THE FACTS ON WHAT IT WILL DO FOR YOU, YOUR COUNTRY, AND YOUR POCKETBOOK 38 (1996). Rep. Armey criticizes the incentives that the current income tax creates for special interest groups to seek special treatment. Id. He slightly misquotes Hayek as saying, “as the coercive power of the state will alone decide who is to have what, the only power worth having will be a share in the exercise of the power [sic].” Id. (misquoting HAYEK, supra note 159, at 107, who stated that the power worth having was “a share in the exercise of this directing power”). While Rep. Armey and other self-identified conservatives are fond of invoking Hayek’s words, Hayek himself eschewed the “conservative” label and instead identified himself as a libertarian. See F.A. HAYEK, Postscript: Why I Am Not A Conservative, in THE CONSTITUTION OF LIBERTY 397-411 (1960).
the tax reform proposals have a social engineering component—they are all designed to discourage consumption and encourage savings and investment.\textsuperscript{191} Indeed, the reform plans do not eliminate tax incentives; they merely replace the existing incentives with a new set.\textsuperscript{192} If this is really what the process is about, the proponents should be more candid about it.

Of course, since the days of the legal realists, jurisprudence has been skeptical of the idea that any legal scheme can be truly “neutral.” In its strong form, the argument against the existence of neutrality holds that because laws will always have distributive effects on private decisions, the law can never achieve neutrality. As it relates to the tax reform debate, however, a conservative could assert that the neutrality argument is overstated. While any intellectually honest proponent of radical tax reform would have to concede that changing the tax system could result in the substitution of one set of socially engineered incentives for another, that proponent might nevertheless argue that there are degrees of non-neutrality. Whereas the current tax scheme specifically favors some sectors of the economy and disfavors others, the reform proposals merely establish rules that generally encourage savings and investment. An intellectually honest opponent of radical tax reform would have to concede the point that, while this may be “social engineering,” it does not have quite the same heavy-handed government involvement as programs that target particular preferences and activities and not others. While these two hypothetical, intellectually honest debaters might view the social engineering point this way, in the actual public policy debate proponents of radical tax reform rally around the elimination of social engineering and do not own up to the reality that they are not actually eliminating social engineering but merely substituting a perhaps less offensive variety of social engineering.

\textsuperscript{191} See \textit{The Nat’l Comm’n on Econ. Growth and Tax Reform, Unleashing America’s Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century} 3-6 (1996), reprinted in \textit{The Kemp Comm’n Recommendations: A Small Business Perspective: Hearing Before the House Comm. on Small Business, 104th Cong. 90-93} (1996). This official report of the National Commission on Economic Growth and Tax Reform, sometimes called the “Kemp Commission” after its chairman, former Congressman Jack Kemp, snidely refers to the mess made by “special interest[s],” \textit{id.} at 3, but then makes no bones about pushing a plan that, in their judgment, is calculated to promote “families” and “growth,” \textit{id.} at 6,—both terms that mean different things to different people and that smack of social engineering.

\textsuperscript{192} Eisner, \textit{supra} note 59, at 44 (“[T]he flat tax substitutes serious new distortions for those it would eliminate.”).
B. Realignment of Tax Federalism

The other major conservative value advanced by radical tax reform is further devolution of government functions, including tax functions, away from Washington.\textsuperscript{193} The conservative-led process of shifting responsibilities for social programs from the federal government to the states has been underway in earnest at least since the Reagan administration.\textsuperscript{194} The proposed tax reforms fit nicely with an overall strategy that seeks to combine several dearly held tenets of conservatism relating to federalism (read: antipathy toward Washington) and the appropriate size of government (read: small).\textsuperscript{195}

First, conservatives prefer that political power be diffused and decentralized.\textsuperscript{196} Second, as a general matter they would prefer

\textsuperscript{193} See Michael J. Boskin, \textit{A Framework for the Tax Reform Debate}, in \textit{Frontiers of Tax Reform}, supra note 25, at 10, 13 ("Tax reforms can affect the federal system in many ways, and we should favor those that strengthen it and devolve authority to state and local government and private institutions to the extent possible."); see also Armey, supra note 104, at 100 ("We flat-taxers are populists. We flat-taxers think the vast resources of this great commercial nation can be better allocated over kitchen tables than over Capitol Hill's green felt tables."). This push to devolve the functions of government is fueled in part by conservative fears that the federal government is out of touch with the average American. For an expression of this sentiment in the tax area, see Payne, supra note 132, at 163-77 (describing the "culture of taxing" in which the federal government imposes taxes while being basically oblivious to the taxpayer, the government does not prepare tax burden studies, the experts who testify before Congress are predominantly IRS officials, past and present, the tax attorneys and accountants have captured the process, and taxpayers do not get actively involved because of the complexity and other constraints on their action). For an intriguing proposal about how to devolve the collection of taxes down to the local level, see Lior Jacob Strahilevitz, \textit{The Uneasy Case for Devolution of the Individual Income Tax}, 85 Iowa L. Rev. 907 (2000) (arguing for a community approach).

\textsuperscript{194} See Advisory Commission on Intergovernmental Relations, \textit{Devolving Federal Program Responsibilities and Revenue Sources to State and Local Governments} (1985) (examining the challenges of state and local governments taking over programs previously administered by the federal government, including the challenge of how to finance the programs).

\textsuperscript{195} These views may be held by people who do not consider themselves "conservatives" as well. See John Kincaid & Richard L. Cole, \textit{Changing Public Attitudes on Power and Taxation in the American Federal System}, 31 PUBLIUS 205 (2001).

The federal government is viewed as providing citizens the least for their money; the federal income tax, followed by local property tax, is seen as the worst tax; a majority of the public indicates that local governments need more power; the public is most likely to identify the federal government as having too much power; and the public is least likely to say that the federal government needs more power.

\textit{Id.} at 205.

\textsuperscript{196} See Clinton Rossiter, \textit{Conservatism in America}, 64-66 (2d ed. 1962) (noting that a core belief of conservatives is the desirability of diffusing and balancing social, economic, cultural and political power); Dunn and Woodard, supra note 155, at 7
government to be as small as possible.197 Third, as discussed above, they generally oppose government social programs that engage in social engineering.198 The primary thrust of the conservative agenda at the national level to address these three points has focused on devolution of federal programs to the states through mechanisms like the block grant, tax-reduction (funded by cuts to programs they do not support), and structural changes designed to make the imposition of new taxes more difficult, on the theory that government growth is fueled by the availability of tax revenues.199 But conservatives are beginning to realize that the total burden of government is growing fastest at the state and local level,200 prompting them to turn their attention to that theater of operations.201

Viewing "government" in all its manifestations—federal, state and local—as one giant "Leviathan" whose sole motive is to maximize its revenues, the conservative tax reform proposals aim to cut the monster down to size.202 The reform proposals do this, as noted above,

("Shared traditional values held conservatism together during the turbulent postwar era. These values emphasized local control, a sense of morality, and respect for tradition.").

197. See Armey, supra note 104, at 100 ("We believe government should be open, honest, direct—and smaller.").

198. See supra notes 160-67 and accompanying text.

199. See Gary S. Becker, Yes, Pass a Flat Tax—But Clamp a Lid on Spending, Bus. WK., July 1, 1996, at 20 (drawing the connection between tax revenue and government size).

200. In the recent economic downturn, many states have had to increase taxes even as the federal government was cutting taxes. See Russell Gold, States' Tax Increases Are Creating a Drag on the Overall Economy, WALL ST. J., June 3, 2002, at A2; Russell Gold, States Are Seen Raising Taxes, Fees in Fiscal '03, WALL ST. J., May 16, 2002, at A2; Tom Herman, States May Need to Raise Taxes As Declines in Revenue Persist, WALL ST. J., Sept. 12, 2002, at D2.

201. See Howard Gleckman, Why Income Tax Cuts Won't Lessen the Tax Bite, Bus. WK., Sept. 30, 1996, at 146 (noting that the overall tax burden in the past thirty years has increased primarily because of increases in payroll taxes and state and local taxes); see also Gary S. Becker, The States Should Find Their Own Way Out of This Hole, BUS. WK., May 26, 2003, at 30 (opining that states have "expanded spending to unsustainable levels").

202. The idea that all levels of government should be lumped together and treated as "Leviathan" is certainly controversial, but one that appeals to the conservative view. See Geoffrey Brennan & James M. Buchanan, The Power to Tax: Analytical Foundations of a Fiscal Constitution 28-30 (1980) (using the terminology of government as "Leviathan" and "Leviathan as monolith"). Concerns about the Leviathan's rapacious appetite may be a bit overblown if one considers the fact that the Leviathan has an encompassing interest in the productivity of the economy that it is feeding off of, and so has a great incentive to moderate its own take of the booty (that is, the Leviathan does not want to kill the goose that lays the golden egg). This idea was recently developed by Mancur Olson. See Mancur Olson, Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships 14-23 (2000). Others have reached similar conclusions about the Leviathan's behavior that
by making the tax burden more visible and fomenting popular opposition to taxes generally. 203 This is easiest to see in the context of a federal retail sales tax or VAT. If those proposals are enacted, states will likely lose the ability to levy income taxes and will rely even more on their own sales taxes or property taxes. But the combined burden from a state and federal sales tax on every economic transaction is bound to cause taxpayers to experience "sticker shock."

The results of such a tax sticker shock are widely anticipated and are, probably, intended consequences of the proposed reforms. Tax commentators have identified several likely results from the increase in state and local tax prices: (a) taxpayer pressure for reduction of state and local taxes and spending; (b) taxpayer opposition to future tax increases; (c) taxpayer hostility to redistributive tax and spending schemes; and (d) political pressure to shift the state and local tax burden away from households and toward businesses (on the assumption that under the typical consumption tax proposal businesses may continue to deduct state and local taxes as ordinary business expenses). 204 While the VAT or sales tax example is easiest to see, all of the proposals will have the effect of making the costs of local government more visible by eliminating deductibility of state and local taxes and increasing the costs of bond financing. Frustrated citizens are likely to lash out in the place they have the loudest voice—town hall and the state house. 205

To the extent that tax reform proposals fuel the dynamic of making the total tax burden more visible and creating a mechanism for local tax reduction, they move toward the three conservative goals mentioned above. First, such a dynamic satisfies the conservative preference that government decisions be made locally, where smaller

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203. See Blackwell, supra note 24, at 276-77 (advocating that taxes be as visible as possible to remind taxpayers what the true cost of government is).

204. Mazerov supra note 50, at 1465-66 (listing the anticipated effects of tax law changes on state and local taxpayer attitudes).

205. This dynamic is what produced the property tax revolts of the late 1970s and 1980s—citizens encountered visible and heavy taxes and they did something about it. See Becker, supra note 199, at 20 ("The argument that resistance to higher taxes is greater when the burden is heavier and more transparent is supported by the fact that property owners led the tax rebellion in many states.").
governmental units are more responsive to individual concerns.\textsuperscript{206} Local political action for tax relief is the most likely course because individuals can have a bigger impact locally where individual votes are less diluted and therefore count relatively more than in national elections.\textsuperscript{207}

Second, if all local governments find themselves in the same boat, they will compete with each other to find the right level of taxes and government benefits.\textsuperscript{208} Although the federal deductibility of state and local taxes has traditionally been justified as a way to prevent sub-federal jurisdictions from competing with each other for tax base,\textsuperscript{209} the elimination of that provision and the other impacts discussed above will promote inter-jurisdictional competition. Inevitably, conservatives believe this will require reductions in taxes and government services, thereby achieving the second goal of reducing the size of government.\textsuperscript{210} In any event, if they find themselves in fiscal distress, state and local governments will be forced to cut programs, and, typically, in times of financial crisis, such cuts come to public assistance and social services.\textsuperscript{211} In some ways, this aspect of the tax reform impact is essentially an attempt

\begin{footnotes}
\item[207.] See generally Gerald E. Frug, Empowering Cities in a Federal System, 19 URBAN LAW. 553 (1987) (noting that, in addition, local group identity fosters the building of consensus and promotes community involvement).
\item[208.] See BRENNAN & BUCHANAN, supra note 202, at 13-26 (advancing the argument that competition among decentralized units of government can break the monopolistic hold of a strong central government). But see William E. Oates, Federalism and Government Finance, in MODERN PUBLIC FINANCE 126, 148 (John M. Quigley & Eugene Smolensky eds., 1994) (noting the lack of unambiguous empirical evidence to support the proposition that decentralization in and of itself constrains the overall size of government).
\item[209.] See Briffault, supra note 68, at 545 (noting the anti-competitive effect of deductibility).
\item[210.] See Eisner, supra note 59, at 74.
\item[211.] See Dick Netzer, The Effect of Tax Simplification on State and Local Governments, in ECONOMIC CONSEQUENCES OF TAX SIMPLIFICATION 222, 234 (Federal Reserve Bank of Boston, 1985) (noting that state and local fiscal crises tend to result in sharp cuts to social programs).
\end{footnotes}
to realize the theoretical predictions of Charles Tiebout's famous model of local expenditures.\footnote{212}

In Tiebout's view, localizing government decisions about how many government services to provide and how much to charge for them would permit the development of a market-style mechanism for satisfying citizen preferences for the appropriate level of government involvement.\footnote{213} Those who do not like the total package of services and taxes in one town can vote with their feet and move to a town that is more suited to their preferences. While the Tiebout model has been a useful idea, it has obvious shortcomings as a descriptive matter.\footnote{214}

Critics point out that the model fails because the exit option is not costless, and, in fact, may be quite costly, and because local taxpayers often lack the information necessary to make the appropriate decisions.\footnote{215} In addition, observed reality indicates that localities supply public goods and services less as a function of local preferences than as a function of local wealth.\footnote{216}

Despite its shortcomings, the model holds great appeal and may, in fact, inform a significant group of policy makers. It continues to have explanatory power for some observed dynamics. For example, a variation of the Tiebout idea justifies the observed competition among states to improve legal regimes.\footnote{217} In the tax arena, however,
many observers worry that interstate tax competition has done more harm than good.\(^{218}\)

Finally, to the extent elimination of social engineering is part of the conservative agenda, moving the focus of taxation to the local level advances that goal as well. Tax analysts have understood for a long time that not all levels of government are equally good at all types of program finance.\(^{219}\) Shifting the tax burden to state and local governments will make financing social programs especially difficult. Of course, from the conservative perspective, one of the most nefarious social engineering schemes is the redistribution of income from the wealthy to the poor.\(^{220}\) By imposing a regressive federal level tax and precluding state and local options for administering an income tax, the new tax regime could effectively eliminate redistribution plans, as local taxation schemes are ill-suited to carry out redistributive efforts.\(^{221}\) To the extent these plans will encourage a popular movement to reduce the tax burden overall or are coupled with tax rebates, that development will also indirectly help the crusade against social engineering.\(^{222}\)

\(^{218}\) FINANCING STATE GOVERNMENT IN THE 1990S, supra note 61, at 29-31 (1993) (noting that "interstate tax competition for economic development can undermine state tax bases, produce tax inequities, and inhibit tax policy reforms—at times without always providing compensatory benefits").

\(^{219}\) See Richard A. Musgrave, Who Should Tax, Where, and What?, in TAX ASSIGNMENT IN FEDERAL COUNTRIES 2, 2-17 (Charles E. McLure, Jr. ed., 1983) (discussing the issue of which level of government is best suited to which kind of program finance).

\(^{220}\) For the classic attack on progressivity and the dangers of redistribution through the income tax scheme, see BLUM & KALVEN, supra note 85, at 70-90 (arguing against progressivity on moral, economic and social grounds).

\(^{221}\) See Paul E. Peterson, Who Should Do What? Divided Responsibility in the Federal System, BROOKINGS REV., Spring 1995, at 6, 9 ("Any locality making a serious attempt to tax the rich and give to the poor will attract more poor citizens and drive away the rich. No amount of determination on the part of local political leaders can make redistributive efforts succeed.").

\(^{222}\) Rep. Weldon of Florida puts the link between reduced tax revenues and reduction in social engineering into a concise package: "The less revenue the Government takes in, the less social engineering, the less redistribution of wealth and the fewer new Government programs the left can oversee. That is why they hate tax relief so much." 145 CONG. REC. H8475 (daily ed. Sept. 22, 1999). Some have suggested that the Republicans intentionally reduce tax revenue and run deficits in order to force the next (presumably Democratic) administration to face the difficult choices for bringing the budget back into balance. This certainly was borne out in the transition from the Reagan administration through the first Bush administration and into the Clinton administration. See Sheldon D. Pollack, Republican Antitax Policy, 91 TAX NOTES 289, 292-93 (2001).
V. CONCLUSION

Radical federal tax reform will have a radical effect on state and local governments. It will curtail revenue raising options, increase the costs of borrowing, and increase the tax price of state and local government services. The traditional goals of tax policy will not be well-served by the wrenching dislocations caused by these radical plans, but the underlying conservative agenda nevertheless supports changes in the tax system. The unstated (or at least understated) reasons for conservative support of federal tax law reform is the desire to bring about two major changes in government power: (1) to remove the tax expenditure device from the federal government as a tool of social engineering; and (2) to push more tax decisions to the state and local level to promote competition between jurisdictions in the hope that a dynamic will develop that shrinks the size of government and cuts social programs.

On close examination, these goals are simplistic and even self-contradictory. With regard to the "elimination" of social engineering, the reform proposals amount to nothing more than the desire to replace one set of government incentives with a different set. On the point of re-balancing fiscal federalism, the push toward local power places too much faith in a Tiebout-like world view. In any event, if the real reasons for tax reform include the ideas developed in this Article, it would be desirable in the name of candor for proponents to put aside the window-dressing language of traditional tax policy analysis and instead talk about what they really want. Radical tax reformers have made little progress in enacting their schemes in part because they have failed to galvanize the American people in a principled, policy-oriented way. If the American citizens want to buy into one of these programs, as honestly stated, it should be enacted, but if they do not agree with the underlying philosophy of the promoters of these radical proposals, the proposals should be set aside and more traditional approaches to tax reform should take center stage.

223. See supra notes 191-92 and accompanying text.
224. See supra notes 212-18 and accompanying text.