The Economic Rape of America - Chapter Eight

HISTORY AND THEORY OF TAX AND STATE

You have sown much, and harvested little; you eat, but you never have enough; you drink, but you never have your fill; you clothe yourselves, but no one is warm; and you that earn wages earn wages to put them into a bag with holes.
-- Haggai 1, verse 6

"... [W]hen it is no longer worth the producers' while to produce, when they are taxed so highly to keep the politicians and their friends on the public payroll that they themselves no longer have a reasonable chance of success in any economic enterprise, then of course production grinds to a halt... When this happens, when the producers can no longer sustain on their backs the increasing load of the parasites, then the activities of the parasites must stop also, but usually not before they have brought down the entire social structure which the producers' activities have created. When the organism dies, the parasite necessarily dies too, but not until the organism has paid for the presence of the parasite with its life. It is in just this way that the major civilizations of the world have collapsed."
-- Professor John Hospers, 1975

The history of taxation is also the history of the rise and fall of civilization. It is the history of economic rape. From the history of taxation we can learn...

TAX IN EGYPT, ROME, AND THE MIDDLE EAST

Charles Adams wrote a superb book, *Fight, Flight and Fraud: The Story of Taxation*. It is a comprehensive analysis of the history of taxation in the context of the rise and fall of civilizations. Starting with Egypt, Adams says:

"The most impressive analysis of Egypt's demise came from the great Russian scholar Rostovtzeff. He believed, after a lifetime of study, that the decay in Egyptian society was the result of lawlessness in the bureaucracy, especially the tax bureau. The king could not restrain it and his orders went unheeded. Rostovtzeff felt that the continual and unabated tyranny of Egyptian tax collectors produced a nationwide decline in incentive. Egyptian workers and farmers lost their desire to work - agricultural lands fell into disuse, businessmen moved away and workers fled. Sound money disappeared as a raging inflation destroyed what capital there was. The land became filled with robbers who wrecked commerce and brought fear and despair to the populace. Boating and sailing along the Nile became as dangerous as walking at night on the back streets of New York and Detroit. In the end, thieves were no longer only in the tax bureau - they were everywhere."

Adams devotes several chapters to Roman taxation and concludes:
"The prevalence of crippling taxation prior to the fall of Rome has led many historians, in all ages, to suspect that Rome, like so many great empires, taxed itself to death. Recently, the tax theory of the Fall has become unfashionable among many scholars - perhaps because of our own tolerance for heavy taxation. No one likes to think we are writing our own obituary when we draft modern tax legislation. If our civilization is to be destroyed, we like to think it will happen Hollywood-style - a cataclysmic event like an

atomic war, an ecological blunder, or some other dramatic happening. Certainly not something so simple and dull as everyday taxation."

"At first, the Muhammadans came as liberators and brought relief to the inhabitants of an over-taxed and enslaved Roman world," writes Adams, but finally:
"The Moslems had led the world right back to where it was before they had arrived on the scene. Only the names had changed. Moslem tax men ended up rivaling the worst of the Roman Empire. Perhaps this picture of Moslem tax chiefs, written centuries ago, best illustrates the end-product of their tax system: 'They were cruel rascals, inventors of a thousand injustices, arrogant and presumptuous... They were the scourges of their age, always with a causeless insult ready in their mouths. Their existence, passed exclusively in oppressing the people of their time, was a disgrace to humanity.'"

Today the IRS uses informers extensively. They receive a percentage of all taxes collected as a result of the information they provide. The IRS even conducts seminars on how to induce people to inform on one another. Contrast this to Emperor Constantine, who abolished torture, crucifixion, and tax informers. He regarded tax informing as more evil than crucifixion. In the year 313 AD he ordained:

"The greatest scourge of mankind, the detestable race of tax informers, must be stopped. We must stifle it in its first efforts and tear out the pernicious tongue of envy. Let not the judges receive... the information of the informer; let them be given up to punishment as soon as any of them appear."

This is the earliest historical record of the Exclusionary Rule, which forbids the use in court of illegally obtained information. What would Constantine have thought of our present bankers who serve as tax-informer handmaidens to the IRS?

TAX IN ENGLAND

In 1215 King John of England was compelled to sign the Magna Carta or "great charter." The Magna Carta guaranteed free trade to merchants within England. It also established the principle of "separation of powers." According to Adams:
"The king could spend but not tax. Parliament could tax but not spend. As long as the power to tax and the power to spend were separated, the rights of Englishmen would live forever, especially the right to be free from oppressive taxation. Today the principle of separation of powers means something quite different. Our current runaway taxation is the natural consequence of our abandonment of that ancient English practice. We live in a pre-Magna Carta world in which we - like the subjects of King John - can be 'pilleth with taxes and tallages unto the bare bones.'"

The first **income** tax was introduced in England in 1404. Very little is known about this tax, because Parliament had every written document and record about it destroyed. Obviously, a substantial number of people recognized it for the evil it was. A short poem about it did survive:
"A monstrous birth shewn to the world,
to let it know what could be done,
and concealed by historians,
and the world might not know
what may not or ought not to be done."

The next income tax in England was implemented in 1799 in the form of the British Income Tax Law. It was adopted to raise revenue to fight Napoleon. According to Adams, "The tax returns of this law show a remarkable similarity to the returns we prepare each April." This 10 percent income tax was adopted on a temporary basis, to be abolished six months after the war with Napoleon ended. However, in 1816 it was still in operation. Most Britons hated the tax and the leader of the opposition "hoped that the country would rise up as one man against it... This extension of bureaucratic power into everyday life might be the herald of an all-embracing tyranny." The tax was repealed by a large majority. Parliament, as with the 1404 income tax, ordered that all the government income tax records be destroyed.

In 1842 Sir Robert Peel adopted a "temporary" 3 percent income tax, which was supposed "to be repealed as soon as government revenues were in balance." Peel admitted, "A certain degree of inquisitorial scrutiny is... inseparable from an income tax." William Gladstone was determined to abolish the income tax. He said, "The inquisition it entails is a most serious disadvantage, and the frauds to which it leads are an evil such as it is not possible to characterize in terms too strong." But the income tax was never repealed. And in 1911, Professor Seligman, a leading American economic scholar observed that the tax had never risen above 6 percent, and the "early complaints against the inquisitorial character of the tax have long since well-nigh completely disappeared."

During the nineteenth century the German states also introduced income tax. According to Adams:
"Unlike the British, the Prussian system summoned taxpayers before revenue authorities for examination. All taxpayers were required to declare and pay their tax. Prussian surveillance was so extensive that one German legislator declared, "The country is covered with a perfect system of espionage." But Prussian oppression was of no concern to the democratic West. Seligman dismissed the Prussian system as an aberration. Such an inquisitorial system "would be impracticable almost anywhere else... Nowhere else are the people so meek in the face of officialdom. In no other country in the world would it be possible to enforce so inquisitorial a procedure as we have learned to be customary in Prussia."

In a few short years this observation by the leading tax expert in America would be contrary to the course of development of every income tax system in the world. The very worst fears of the alarmist in the Napoleonic era would come to pass. The spirit of Britain's modest income tax would become outmoded and unworkable; while the spirit of the Prussian income tax system would soon infect every nation on earth. In short, the British invented the form of our modern income tax laws - but the Prussians gave us the muscle by which they now operate."

THE AMERICAN TAX REVOLUTION

The revolt of the Thirteen Colonies of British North America was rooted in taxation. After the war of independence there was general agreement that there should not be a national government with taxing power. In 1773 Benjamin Franklin had written an article: "Rules by which a Great Empire may be reduced to a Small One." Examples:

- "But remember to make your arbitrary tax more grievous to your provinces, by public declarations importing that your power of taxing them without their consent

has **no limits**; so that when you take from them without their consent one shilling in a pound, you have a clear right to the other 19."

- To make your taxes more odious, and more likely to procure resistance, send from the capital a board of officers to superintend the collection, composed of the most **indiscreet**, **ill-bred**, and **insolent** you can find... If any revenue officers are **suspected** of the least tenderness for the people discard them. If others are justly complained of, protect and reward them. If any of the under officers behave so as to provoke the people to drub them, promote those to better offices... "

THE AMERICAN TAX WAR

Adams provides conclusive evidence that the American Civil War - more accurately, "the Rich Man's War and the Poor Man's Fight" - was caused by taxation. I think we should call it the "American Tax War." At the time the South paid about three-quarters of all federal taxes. The tax system shifted wealth from the South to the North. The proverbial "straw that broke the camel's back" was the Morill Tariff, passed by Congress in 1861, and signed by Abraham Lincoln. According to Adams:

"It doubled the rates of the 1857 tariff to about 47 percent of the value of the imported products. This was Lincoln's big victory. His supporters were jubilant. He had fulfilled his campaign and IOUs to the Northern industrialists. By this act he had closed the door for any reconciliation with the South. In his inaugural address he had also committed himself to collect customs in the South even if there was a secession...

Jefferson Davis, the first president of the Confederacy, justified secession in his inaugural address by making reference to the Declaration of Independence then emphasizing the import tax issue."

The North, led by Abraham Lincoln, practiced economic rape against the South. The result was a war in which more than 300,000 died. The Civil War was fought over taxes, not slavery. It was two years after the start of the war before Lincoln issued the Emancipation Proclamation. Can we surmise that by 1861 Americans had forgotten the history lessons they could have learned from 1776?

THE BIRTH OF BIG BROTHER

According to Adams:
"The year 1894 may have been civilization's most important tax year. Britain adopted new death duties with progressive rates and the United States adopted an income tax. The progressive rates in Britain soon applied to income taxation everywhere. The taxing habits of civilization would never be the same again. In the United States the income tax and the estate tax would soon revolutionize society. The connection between the real 1894 and Orwell's fictitious *1984* may turn out to be more than a transposition of numbers. If Orwell's society with its all-seeing Big Brother comes to Western Civilization, roots of that Frankensteinian monster may be traced to the tax laws of 1894."

Have you ever wondered why Big Brother uses the term "duty?" Death duties, import duty. It is your "duty" to pay your "fair share." People who don't pay their "duty" or "fair share" are "tax cheats."

Adams quotes the reaction of a former British Chancellor of the Exchequer to the 1894 income tax:
"But where are you going to find a standard of what it is right to take? ... I think the standard will vary from Parliament to Parliament and from majority to majority; and the principle of taxation will depend on the wave of public opinion, and not on the equality of taxation which has been insisted upon in our finances... I am anxious that this graduation should not become a kind of scaffolding for plunder... there is the possibility of inflicting injustice after injustice because you will have no standard to guide you - no landmarks to place along this road of taxation."

Within a year of passing the 1894 U.S. income tax, it was challenged in the Supreme Court in the case Pollock v. Farmers Loan and Trust Co. A lawyer summed up the importance of the case:
"No member of this court will live long enough to hear a case which will involve a question more important than this, the preservation of the fundamental rights of property and equality before the law, and the ability of the United States to rely upon the guarantees of the Constitution... There is protection now or never."

The 1894 income tax was a 2 percent tax on income above $4,000. Only 2% of the population had that high an income. One lawyer argued, "If the rate is 2 percent today, it could be 20 percent tomorrow." Another said, "Once you have decided that the many can tax the few, it will be impossible to take a backward step." The **Supreme Court repealed that income tax as unconstitutional**. Today practically all U.S. judges, in tax matters, will rule references to the Constitution inadmissible. If a defendant persists in raising Constitutional issues, the judge will find him or her guilty of contempt and impose a jail sentence!

In 1913 - the same year the Federal Reserve Act was passed - the Sixteenth Amendment was adopted. (Though some claim that it was never legally ratified.) It states:
"The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, without regard to any census or enumerations."

In *To Harass Our People: The IRS and Government Abuse of Power*, Congressman George Hansen asks:
"By what possible stretch of the imagination can current IRS procedures be justified under this Amendment? Does the Sixteenth Amendment repeal the First, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth and Tenth Amendments? Certainly the examples in this book would indicate that the IRS seems to think so."

So 1913 gave birth to our income tax and the modern IRS. Throughout the latter half of the 19th Century, the British income tax rate remained at 3 percent. Proponents of the U.S. income tax held this up as proof that fears of runaway tax rates were unfounded. According to Charles Adams:
"... [T]he United States Constitution intended to prevent Congress from having a blanket power to tax without standards assuring fairness and preventing oppression. The current horrors in America's income tax law, which President Carter called "a disgrace to the human race," came about because Congress has no standards to follow. As a result the

words of Hamilton in The Federalist have come to pass - the federal government has "trampled on the rules of justice," as he predicted."

In *Restoring the American Dream* Robert Ringer writes:
"When the Sixteenth Amendment to the Constitution became law in 1913, an important step was taken in laying the groundwork for the destruction of the spirit that had made America the freest, strongest and most prosperous country in history. ... [T]he powerholders of that day arbitrarily decided (as they do through all Amendments) to take away a right guaranteed by the Constitution.

The key element in the Sixteenth Amendment was that it gave government the power... to levy taxes against incomes. Just as important, it left the interpretation of the word "income" up to the courts, which meant that from that point on the rules could be changed at the discretion of the government."

In 1910 Senator Richard E. Byrd had this to say about the passage of the Sixteenth Amendment:
"It means that the state must give up a legitimate and long-established source of revenue and yield it to the Federal government. It means that the state actually invited the Federal government to invade its territory, to oust its jurisdiction and to establish Federal dominion within the innermost citadel of reserved rights of the Commonwealth. This amendment... will extend the Federal power so as to reach the citizens in the ordinary business of life. A hand from Washington will be stretched out and placed upon every man's business; the eye of a Federal inspector will be in every man's counting house.

The law will of necessity have inquisitorial features, it will provide penalties. It will create a complicated machinery. Under it businessmen will be hauled into courts distant from their homes. Heavy fines imposed by distant and unfamiliar tribunals will constantly menace the taxpayer.

An army of Federal inspectors, spies and detectives will descend upon the state. They will compel men of business to show their books and disclose the secrets of their affairs. They will dictate forms of bookkeeping. They will require statements and affidavits. On the one hand the inspector can blackmail the taxpayer and on the other, he can profit by selling his secret to his competitor.

When the Federal government gets a stranglehold on the individual businessman, state lines will exist nowhere but on the maps. Its agents will everywhere supervise the commercial life of the states... "

CAN WE CHANGE
OR ABOLISH THE IRS?

According to Charles Adams (*Fight, Flight and Fraud: The Story of Taxation*):
"In 1974, decriminalization of tax offences was suggested by Donald Alexander, tax chief for the United States - a move which would have curtailed the operations of the "special agents" of the IRS. These "tough guys" of the revenue, who had become a kind of institutionalized J. Edgar Hoover, were not about to have their power diminished. Alexander's character was attacked and eventually a grand jury was called to look into

his activities. In the end, Alexander abandoned his plan and acknowledged that about all he accomplished was the activation of his bleeding ulcer."

And according to Congressman Hansen:
"Without commenting on their guilt or innocence, responsibility or lack of same, I am here raising the question that if the subject of national concern is the abuse of the civil rights of our citizens, **where is there a single indictment or prosecution** of an IRS official or employee for proved violations of decent citizens?

The answer is that there have been none and there will be none. When a Commissioner of Internal Revenue can say to the House Committee on Ways and Means that "the truth is that... the only way we can keep people in line, the only way we can keep them honest... is to keep them afraid," then we know that the IRS is immune from retribution. Every prosecutor, every judge, every legislator, as well as every citizen, is subject to the same fear.

In his "House Divided" speech Abraham Lincoln told us an eternal truth. No nation can exist half slave and half free. We have, almost inadvertently, created an agency within the government at war with our freedoms. If it is not curbed, in our view, if it is not destroyed, it will inevitably control us all."

On April 17, 1991 Patrick Buchanan's syndicated column appeared in the *Blade-Citizen* under the heading, "Abolish the Federal Income Tax?" He starts off with some history. Up to 1913 the federal government got its revenue from tariffs and fees. From 1789 to 1913, the U.S. developed from a small farming community into "the greatest industrial power on earth - with growth rates unequaled since."

After the passage of the Sixteenth Amendment in 1913, federal income tax was imposed. The rate was one percent for incomes over $3,000 ($4,000 for married couples). For incomes between $20,000 and $500,000 the rate went up to 6%. By 1950 the average family was taxed two percent of its income by the IRS. By 1990, however, it had gone up to 24 percent.

Buchanan suggests that the income tax be replaced by a federal retail sales tax of 16 percent. Taxes on corporations, estates, and gifts would also be abolished. The federal government would still get the same income. Advantages:

- Savings would explode.
- Corporations would be much more profitable.
- More capital would be available.
- U.S. goods would be cheaper and could compete more favorably in international markets.
- The IRS could be virtually shut down - 94 percent of its work involves income taxes.
- All the time wasted on filling out tax forms would be saved - 5.3 billion man-hours per year = $53 billion at $10 per hour. No April 15th.
- The underground economy that now evades most taxes, "could not escape the 16 percent sales tax at the grocery store, restaurant, department store or auto showroom.
- Foreigners and illegal aliens would pay taxes through their purchases.

- Would yield an extra $100 billion in tax.
- No harassing waitresses.
- Accounting expenses eliminated.
- Hundreds of thousands of IRS agents, tax lawyers, and accountants would be released for productive work.
- Workers would take home all the money they earned, including overtime.
- America would become the best country in the world to work and invest in.
- Foreign capital would flood into the country, creating millions of new jobs.

In my opinion, such a tax would still involve a huge police force; millions of people will evade it. Be that as it may, what really needs to be abolished is the taxing power, including the "currency-tax." Any monopoly power to issue currency is also a taxing power. The issue of monopoly currency transfers value from the producer to the issuer. It is a hidden tax. It manifests as price inflation - the loss of value of the currency. The IRS represents a second taxing power. Both taxing powers need to be abolished.

It is no accident that both the Federal Reserve System and the modern IRS have their origins in 1913. The same senator Nelson Aldrich who played a key role in passing the Federal Reserve Act, was also the kingpin that pushed the Sixteenth Amendment through Congress. As we saw in Chapter Three, Aldrich was the grandfather of Nelson Aldrich Rockefeller. Around the end of WW II, income tax withholding was introduced. One of the prime movers of withholding was Beardsley Ruml, Chairman of the Federal Reserve Bank of New York. Could this mean that the IRS is really the Gestapo of the Federal Reserve Bankers?

THE PRINCIPLES OF TAXATION

From the history of taxation, I believe we can deduce certain principles. In moments of wishful thinking, I imagine that somewhere, sometime some clever people will create a civilization where these principles are understood and applied:

1. Tax is terminal. Any civilization that introduces taxation will eventually tax itself to death.
2. Generally a civilization has a lifespan of more than a hundred years. The time period between the introduction of taxation and the collapse of the civilization also tends to be more than a hundred years. This period is more than the current human lifespan. Taxes tend to start at a low rate and are gradually increased over many years - "the frog that is gradually cooked." Also, the introduction and raising of taxes are invariably accompanied with extensive propaganda to brainwash taxpayers. For these reasons it is very difficult for an individual to appreciate the nature of taxation and its consequences.
3. The monopoly power to issue currency is a power to tax in the form of inflation. Anyone with a monopoly power to issue currency, will use this power to tax users of the currency at a gradually increasing rate, until the currency loses all its value.
4. Tax is theft, legalized robbery, crime. Some people use intimidation, fraud, coercion, force, threat of force, violence, and terror to rob other people of their property, the fruit of their labor. Tax is economic rape. In the final analysis, tax is collected at the point of a gun.

5. Tax is parasitism. It involves some people living as parasites off the production of others.
6. Tax is the modern incarnation of cannibalism. Property, including what we produce, are extensions of our bodies - human capital. Taxation is the forcible, cannibalistic consumption by some of the human capital of others - "eat out their substance." Tax destroys human capital.
7. Tax penalizes the producer and rewards the destroyer - it takes from the producer and gives to the destroyer. Over time this leads to destruction of production.
8. Tax is like cancer. Once it takes hold in a society it grows and spreads.
9. Tax establishes the moral principle that might is right, the strong take from the weak, the many from the few. Tax destroys morality.
   Morally, tax is similar to a mafia protection racket - with the difference that the mafiosi operate in a simple, straightforward manner ("Pay up, or else!"); while tax collectors clothe their economic rape in high-sounding hypocrisy ("Pay your fair share!; for the good of society!; voluntary compliance!").
10. Tax laws, rules, and regulations grow in number and complexity to the point that any taxpayer can be prosecuted for being a tax criminal, no matter how much tax he or she pays.
11. With few exceptions, "tax reform" increases taxes and makes the tax laws, rules, and regulations more complex, numerous, and voluminous. As this happens, the taxed society develops a class of "tax protectors" - attorneys, accountants, and advisors, who take advantage of "tax loopholes." But many of them merely use the tax system to prey off its victims.
12. Over time, in every taxed society, tax collectors tend to become more vicious, violent, and criminal - eventually becoming a terrorist Gestapo.
13. Tax collectors develop informer and entrapment systems. They encourage neighbor to spy upon neighbor. Banks become a central part of their informer-network. They use secret agents to provoke their victims into committing "tax crimes."
14. In every taxed society the justice system becomes closely linked with the tax system. Judges become corrupt tax collectors. The police becomes a criminal class. People lose all respect for "the law."
15. In every taxed society the tax system develops into a social control mechanism that is particularly used against "dissidents" and "public enemies" who can't be otherwise neutralized.
16. In every taxed society the tax system is used to violate individual rights and to eventually destroy individual liberty.
17. In every taxed society the most devious, parasitic and cannibalistic criminals tend to rise to the top. The "great leaders" of a taxed society tend to be the most murderous monsters of history.
18. Tax finances war. The power to tax is the power to conduct war.

LITURGY, ONE ALTERNATIVE TO TAXATION

We live in a world of infinite possibility, but in a culture of severe limitation. We have been brainwashed with "nothing is as certain as death and taxes." For us to imagine a world without taxes is almost like a fish trying to live other than in water. We are stuck in constricting constructions of thought like, "If we don't have taxes, we must have "X" as the only alternative; "X" is evil; therefore we must have taxes." The fact is, however, that

we have an infinite number of alternatives to taxation potentially available to us. We just have never thought of them.

Nevertheless, the ancient Greeks did think of an alternative to taxation. Charles Adams, in F*ight, Flight and Fraud: The Story of Taxation*, describes it as "revenue sharing without bureaucracy":
"When a city needed a new public improvement or activity, such as a bridge, or perhaps a play or festival, the leading citizens were called upon to provide what was wanted. It was not a tax or confiscation of any kind. Called a liturgy, this was a voluntary contribution to the city-state. It was enforced by nothing more than tradition and strong public sentiment. Public amusements, athletic games and military equipment were purchased by rich citizens and donated to the city. A certain amount was expected of each rich citizen, but most of them gave more than was asked...

The practice of liturgies created a new sense of private property. Those who had wealth held it in a kind of voluntary trust for the city. Ownership of property involved duties more than it involved rights. This was the Greeks' brilliant alternative to government ownership and bureaucratic control which typified the oriental despotisms of that day and the governments of our day. The rationale was that property, by the natural order of things, was bestowed on those best able to acquire and manage it, but those so endowed were obligated to hold it for the community as it was needed. This system permitted the management of the excessive wealth of the private citizen for the whole community without government bureaucracy - something no other people has been able to do, either before or since the days of the ancient Greeks. Waste and inefficiency that is so inherent in bureaucratic life was replaced by private enterprise for the public good.

The private donor actually managed and directed the public improvement or activity. If a bridge was needed the wealthy citizen actually built the bridge. For his work and money the donor was honored. The city-state government had little to do except to push the project along. Under the system the public received the most from the donor's money. His management talent was free.

Today we shift a great deal of private wealth to the public sector through heavy taxation and government-managed expenditures. The costs are enormous. Worst of all is the spirit of the whole operation. The donors are neither respected nor honored for their benevolence. In fact, the taxpayer, however high the tax he pays, does not know where his money goes. He pays because the alternative is prison and he never pays more than the law demands, if that much. Paying three or four times as much tax as the law demands is unheard-of in our society. Our governments exact taxes with the arrogance of an owner, somewhat like the attitude of Louis XIV as expressed by one of his aides: "All the wealth of his subjects was his, and when he took it he took only what belonged to him." This is the attitude of the despots, which the Greeks understood so well and tried so hard to avoid through the system of liturgies.

Scholars have taken strong positions both for and against the liturgy. It cannot be questioned, however, that the liturgy was the device by which the Greeks achieved civilization without despotism. When a government takes wealth by force and claim of right, it is inclined to trample on the people's property rights and liberties. On the other hand, if private wealth is spent without social conscience on the extravagances of individuals, the less fortunate suffer and are often driven to violence and revolution. The

liturgy was a solution to the dilemma of too much versus too little government intervention in the accumulation of private property. The interests of the community and the individual were reasonably balanced. The liturgy respected private property, but it also induced the wealthy to shoulder the main burden of providing for the needs of the community - and the genius of the system lay in the fact that no police power was needed to achieve those ends.

Under a liturgy system there is no place for the games of avoidance and evasion that characterize our tax systems. Loopholes, tax gimmicks and tax shelters have no place. Every citizen should shoulder his fair share of the costs of maintaining government and providing for the needs of the community. This kind of patriotism is not jingoistic; without it liturgy will not work.

The Greek practice of liturgies survived the city-states. But when the Romans demanded liturgies from their conquered cities with the muscles of the legions, this was no longer voluntary contribution. Now it was legalized robbery or, to be more sophisticated, the confiscation of private property for government use without just compensation."

THE ORIGIN AND DEVELOPMENT OF THE STATE

In *Parliament of Whores*, P.J. O'Rourke describes a town meeting in "Blatherboro," New Hampshire. It is a little town whose inhabitants are extraordinarily decent. The citizens are educated, sensible, and all employed. In 1989 the town spent $21,000 on public assistance. All the money was supplied by private charitable donations. But, writes O'Rourke:

"... [T]he result of the annual town meeting is always a stupid and expensive mess. Much of the stupidity is common to all government... Blatherboro has fifteen police officers - the same ratio of police to population as New York City. The annual Blatherboro police budget is $425,000. This in a town that, in 1989, had 520 crimes, of which 155 were minor incidents of teenage vandalism. The cost of police protection against the remaining 365 more or less serious malefactions was $1,164 each - more than the damage caused by any of them."

O'Rourke then describes the school system. The drop-out rate is around 36% - similar to the rates in most inner-city slums. Yet in Blatherboro they spend three times the national average per student. He describes other stupidities, like Blatherboro having to build a $6.2 million unnecessary water system in order to comply with the Safe Drinking Water Act of 1982. Failure to comply would have subjected the town to a fine of $25,000 per day.

Then came the great sewer debate. A golf-course developer had handled all the legal obstacles in order to build a golf course and a condominium complex. He had punctiliously met all the requirements of the Planning Board and other agencies - he obtained forty-seven permits from eleven different government agencies. Construction was already underway. But some of the townspeople wanted to "control growth." The last possible way to stop the development was to pass a local regulation requiring that any extension to the town's sewage system costing more than $50,000, would have to be approved by a special town meeting! O'Rourke continues:

"It was at this moment, in the middle of the Blatherboro sewer debate, that I achieved enlightenment about government... It wasn't mere disillusionment that I experienced. Government isn't a good way to solve problems; I already knew that. And I'd been to Washington and seen for myself that government is concerned mostly with self-perpetuation and is subject to fantastic ideas about its own capabilities. I understood that government is wasteful of the nation's resources, immune to common sense and subject to pressure from every half-organized bouquet of assholes. I had observed, in person, government solemnity in debate of ridiculous issues and frivolity in execution of serious duties. I was fully aware that government is distrustful and disrespectful toward average Americans while being easily gulled by Americans with money, influence, or fame. What I hadn't realized was **government is morally wrong**.

The whole idea of our government is this: If enough people get together and act in concert, they can take something and not pay for it. And here, in small-town New Hampshire, in this veritable world's capital of probity, we were about to commit just such a theft. If we could collect sufficient votes in favor of special town meetings about sewers, we could make a golf course and condominium complex disappear for free. We were going to use our suffrage to steal a fellow citizen's property rights. We weren't even going to take the manly risk of holding him up at gunpoint."

The first imperative of human behavior is: **Survival or self-preservation**. The second imperative is: **Obtain the means for survival through the least effort**. There are two basic ways to obtain the means for survival: **Working** and **Stealing**. Working is called the **economic means**. Stealing is the **political means**. The private sector or free market utilizes the economic means; the public sector or government, the political means. In his book *The State*, Franz Oppenheimer says:

"The State, completely in its genesis, essentially and almost completely during the first stages of its existence, is a social institution, forced by a victorious group of men on a defeated group, with the sole purpose of regulating the dominion of the victorious group over the vanquished, and securing itself against revolt from within and attacks from aboard. Teleologically, this dominion had no other purpose than the economic exploitation of the vanquished by the victors. No primitive state known to history originated in any other manner."

Oppenheimer was a sociologist who studied many peoples: Americans, Barbarians, Chinese, Dutch, Egyptians, Franks, Germans, Huns, Indians, Japanese, Kafirs, Lapps, Macedonians, Normans, Ostrogoths, Quakers, Romans, Saracens, Turks, Ugvarks, Vikings, Wassanai, Xhosas, Yankees, Zulus, and many others.

So Moses said to the people, "Arm some of your number for the war, so that they may go against Midian, to execute the Lord's vengeance on Midian. You shall send a thousand from each of the tribes of Israel to the war." So out of the thousands of Israel, a thousand from each tribe were conscripted, twelve thousand armed for battle... They did battle against Midian, as the Lord had commanded Moses, and killed every male... The Israelites took the women of Midian and their little ones captive; and they took all their cattle, their flocks, and all their goods as booty. All their towns where they had settled, and all their encampments, they burned, but they took all the spoil and all the booty, both

people and animals. Then they brought the captives and the booty and the spoil to Moses... Moses became angry with the officers of the army, the commanders of thousands and the commanders of hundreds... Moses said to them, "Have you allowed all the women to live? These women here... made the Israelites act treacherously against the Lord... so that the plague came among the congregation of the Lord. Now therefore, kill every male among the little ones, and kill every woman who has known a man by sleeping with him. But all the young girls who have not known a man by sleeping with him, keep alive for yourselves.
Numbers 31, verses 3-18

Oppenheimer describes four stages in the development of the state. The **first** "comprises robbery and killing... of men, carrying away of children and women, looting of herds, and burning of dwellings."

The **second** stage starts when the conqueror spares his victim in order to exploit him. It is the origin of slavery. The victim, ceases to resist and becomes a slave who pays tribute to the conqueror.

The **third** stage comprises the "integration" of the master and slave, involving a "stream of sympathy, a sense of common service."

The **fourth** stage occurs when the master and the slave have been "integrated" to the point that they speak the same language, a union between the ethnic groups has developed on a defined territory.

I see three further stages. The **fifth** stage involves the development of a third class: the welfare-recipient. In the U.S. this stage started in the early thirties. We now have three classes: masters, slaves, and welfare-recipients.

The **sixth** stage occurs when the burden of the slaves in supporting the masters and the welfare recipients, becomes too onerous for the slaves to tolerate and they revolt. Hyperinflation may also occur.

The **seventh** stage is a hypothetical stage we may never reach. In stage seven people have abandoned the political means for the economic. They have learned voluntary cooperation.

The important principle to realize is that:
AS LONG AS THERE ARE WILLING SLAVES (TAXPAYERS), THERE WILL BE MASTERS (THE STATE) TO TAX AND EXPLOIT THE SLAVES. This is because of the second principle of human behavior: **Obtain the means for survival through the least effort.**

In addition to Franz Oppenheimer, I am also indebted to George Roche for my understanding of the origin of the state. Roche is the author of a brilliant book, *America by the Throat: The Stranglehold of Federal Bureaucracy*. Basically he describes bureaucracy as the organization of the political means. Roche answered the question for me: What fundamental of human nature - what basic impulse - gives rise to the state, that is, organized theft? He writes:

"... [T]he impulse toward bureaucratic growth is fueled by simple human greed. For this we turn again to the insights of Albert Jay Nock in his classic 1935 essay, *Our Enemy, the State*. This work developed the earlier sociological research of Franz Oppenheimer, who had observed that throughout history, without exception, "Wherever opportunity offers, and man possesses the power, he prefers political to economic means for the preservation of his life." Baldly stated, men would rather steal than earn a living **if** they have a way to do so easily.

From Herbert Spencer and Henry George, Nock had learned "the formula that man tends always to satisfy his needs and desires with the least possible exertion."

These two basic principles of behavior come together in an almost blinding insight about the human condition. Nock recalled that it occurred at a luncheon with his friend Edward Epstean, to whom his book was dedicated. He described the incident in his autobiography:

"I do not recall what subject was under discussion at the moment; but whatever it was, it led to Mr. Epstean's shaking a forefinger at me, and saying with great emphasis, "I tell you, if self-preservation is the first law of human conduct, exploitation is the second."

The remark instantly touched off a tremendous flashlight in my mind. I saw the generalization which had been staring me in the face for years... If this formula (of Spencer and George) were sound, as unquestionably it is, then certainly exploitation would be an inescapable corollary, because the easiest way to satisfy one's needs and desires is by exploitation...

In an essay which I published some time ago (*Our Enemy, the State*), having occasion to refer to this formula, I gave it the name of Epstean's law... Man tends always to satisfy his needs and desires with the least possible exertion."

Armed with this insight, Nock demolished all pretense that the state could ever become a benevolent institution or serve the interests of society. The State **is the organization of the political means**. Its sole purpose is the economic exploitation of one class by another. The State originated historically for purposes of exploitation, and exploitative it remains; it cannot change its nature."

Let us explore the six stages in the development of the state in more detail. A long time ago there were four basic occupations: hunter-gatherers, nomadic herdsmen, peasant-farmers, and fishermen. One of these groups developed systematic plunder as a way of life. It was the herdsmen, because the easiest way for them to expand their herds was to raid other herdsmen. So they started raiding each other to steal livestock. They were mobile and had domesticated horses and camels. They inhabited mainly plains and desert areas, suitable for grazing their animals, but not fertile enough for agriculture. They developed weaponry. Next they started raiding farming communities. They raided, killed, looted, and left. They became known as "hordes." This was the **first** stage in the development of the state. We could regard the organization and actions of these warrior tribes as the "state in embryo." In order to succeed they had to operate like an army. Somebody had to be in charge, and the others had to follow orders. According to Oppenheimer, they "developed a science of tactical maneuvers, strict subordination, and

firm discipline." Roche sees the genesis of bureaucracy in this prehistoric military organization. He writes:

"What I, as a historian, find so interesting about all this, is that bureaucracy must have antedated government by millennia.... The irresistible conclusion is that the State was invented by bureaucrats, and not the other way around! All the evidence supports this conclusion...

In a system of violence and plunder, some must die for others to live... The plunder system is thus a sort of cannibalism, with part of the human race feeding off the rest. This is still so [today], but the system has been immensely refined."

After centuries of such raids, some bright warrior made the revolutionary discovery that the conquered peasant-farmer was worth more alive than dead. This is the origin of slavery, and the **second** stage in the development of the state. Writes Oppenheimer, "The ownership of **slaves**! The nomad is the inventor of slavery, and thereby has created the seedling of the State, the first economic exploitation of man by man."

The nomads added "human stock" to their livestock. Their nomad military bureaucracy was adapted to manage and control their slaves. According to Oppenheimer, what made this possible is that "the peasantry do not flee. The peasant is attached to his ground, and has been used to regular work. He remains, yields to subjection, and pays tribute to his conqueror; **that is the genesis of the land states in the old world**."

Now there is a common interest between the master and the slave. The master comes to depend on the slave's tribute; and the slave, on the master's protection. Eventually they come to speak the same language. Integration of culture occurs. Emotional bonds between master and slave develop. This is the **third** stage of the development of the state.

The **fourth** stage occurs when the masters define a territory in which they own all the slaves and land. According to Roche, "The nomads have abandoned their economic role as herdsmen for a new and wholly political job. They own the territory **and** its people." But despite its bloody origin, the state, in its early stages, becomes a civilizing factor because of the common interests between the master and the slave, and the economics of slavery. Just as the herdsmen looks after their livestock, the masters care for their slaves. According to Oppenheimer:

"The raiders burn and kill only so far as is necessary to enforce a wholesome respect, or to break an isolated resistance. But in general, principally in accordance with a developing customary right - the first germ of the development of all public law - the herdsman now appropriates only the surplus of the peasant. That is to say, he leaves the peasant his house, his gear and his provisions up to the next crop... The peasant thus obtains a semblance of **right** to the bare necessaries of life; so that it comes to be regarded **wrong** to kill an unresisting man or to strip him of everything."

Can we see this pattern in the original U.S. Constitution? Most of it deals with the powers of the government, including taxing powers; not too much about the rights of the people. There must have been tremendous opposition to the original Constitution, so the

Bill of Rights was added to increase the rights of the people. In my opinion, it is the Bill of Rights, more than anything else, that made America a great civilization.

In its **fifth** stage of development the state becomes a "welfare state." In addition to masters and slaves, a third class arises: the welfare-recipient. The New Deal of the thirties was the flowering of stage five. There are two sub-classes of welfare-recipients: non-producers and certain state-contractors. The non-producers essentially produce nothing and live off handouts from the state. The state-contractors I refer to here are those who are overpaid for the goods or services they provide to the state. The military-industrial-complex is the prime example. Ross Perot also comes to mind. According to David Hapgood (*The Screwing of the Average Man*):

"Towering over such petty hustlers is the imposing figure of H. Ross Perot. Hardly anyone had heard of Perot when, in 1969, he was made a director of the Nixon Foundation... By the following year... Perot was worth around $1.5 billion, and *Fortune* magazine offered the observation that no American had ever made so much money in so short a time. Perot... made his fortune out of government funds for the old and the poor. He founded an electronic data processing firm which picked off Medicare and Medicaid contracts all over the country. His bid was often higher than anyone else's, but somehow he landed the contracts, and his profit rate ran as high as 41 percent. Perot was evidently hard to resist; when New York State bureaucrats chose another bidder, Perot appeared in the office of then Governor Nelson A. Rockefeller, and on the governor's orders Perot got back on the inside track. ... [T]he fortune Perot made out of public money works out to an average contribution of almost $19 from each taxpayer in the land."

During stage five, government becomes much more complex. Among other things, it needs to "administer" the non-producing welfare-recipients and the state-contractors. Bureaucracy and government spending start growing explosively. Taxes rise steeply.

The present U.S. is a perfect example of the next stage. Bureaucracy and government spending are huge and ballooning out of control. During the **sixth** stage of the development of the state, the state has become an almost unlimited license to steal. A morality has arisen in which people's desires have become needs, and their needs have become "rights" - which must be guaranteed by the state - like "universal health care." This morality is epitomized by a front-page headline of the Arizona Republic of July 20, 1992: "Good health 'a human right' ... The chairman of the eighth International Conference on AIDS issued a dramatic call Sunday for a new world political movement organized around the issue of health, saying it is time to "champion the principle that health is a human right, not a privilege."" George Roche describes stage six perfectly:

"Physical fear of the conqueror turns into psychological dependence; the State is accepted as the supreme power, a god, a protector and dispenser of justice. Its agents assume the aura of a priestly class, in the vestments of authority; and its exactions become irresistible. No longer can subjects question the right of the State to take what it will, for their minds are enslaved along with their bodies. The state is god. The honest dealings of men give way to greed, and greed to glory. The masses are forced not to bake bread but to build pyramids."

Eventually the burden of the slaves in supporting the masters and the welfare recipients, becomes too onerous for the slaves to tolerate and they revolt. The growing tax rebellion in the U.S. is typical of stage six. The former Soviet Union completed stage six in 1991 when it broke apart. The stage six explosion of bureaucracy, and government spending and debt, may produce hyperinflation. Civilization may collapse.

After a revolution, people tend to return to an earlier stage of government or state, perhaps on a different territorial basis, as in the case of the former Soviet Union. The **seventh** stage is a hypothetical stage we may never reach. It is called , **Freedom**, **Self-government** or **Free Enterprise**. People have abandoned the political means for the economic. They have learned voluntary cooperation. Ancient Greece with its liturgy system probably came close to stage seven. The Declaration of Independence was an example of an advance to stage seven.

In her superb book, *The Discovery of Freedom: Man's Struggle Against Authority*, Rose Wilder Lane describes three attempts to achieve and maintain free societies. The first attempt started four thousand years ago when Abraham "taught his increasing family that men are free." It continued with Moses in Egypt, "Over and over he told them that they were responsible for themselves, that each one of them was free... " He gave them the Ten Commandments, which were **all negatives** - "Thou shalt not steal." And two thousand years ago Jesus "preached that men are free."

Lane describes the second attempt:
"About thirteen hundred years ago a self-made business man began the second attempt to establish the fact of individual freedom in practical affairs." Mohammed started teaching in Mecca that, "Each individual is self-controlling and responsible... There is no superior **kind** of man; men are humanly equal. The Emperor has no actual power over anyone... a priest is no holier or more powerful than any other man, either... Mohammed said that some men are prophets. The greatest, he said, are Abraham, Moses, and Christ... The knowledge that men are free swept across the known world... In eighty years the world was Moslem from the Indian Ocean to the Atlantic... Europeans called them Saracens...

They opened their schools; from Baghdad to Granada... These universities had no organization whatever. (Mohammed said that organization corrupts knowledge.) A Saracen university had no program, no curriculum, no departments, no rules, no examinations; it gave no degrees nor diplomas. It was simply an institution of learning. Not of teaching, but of learning. A man, young or old, went to a university to learn what he wanted to know, just as an American goes to a grocery to get the food he wants... The Saracens' free minds first grasped that concept: zero... "

Lane continues to describe the Saracens' monumental achievements in mathematics, astronomy, navigation, medicine, surgery, anesthesia, science, art, agriculture (contour plowing, fertilization, irrigation, and crop rotation), manufacturing, commerce, transport, free trade, and postal services. They created a civilization with these features:

"It is scientific, constantly increasing and using scientific knowledge. Its essential function is not war, but production and distribution of goods. It is tolerant of all races and creeds; it is humane. Its standard of living, including standards of cleanliness and health,

is the highest in the world. Its tempo is increasingly rapid, and great speed in communication and transportation is necessary to its existence...

The Saracens evidently got along very well for nearly a thousand years with no law. They modified, in many ways, the pure anarchy of freedom. From the past, they kept tribal customs. They increased the natural authority of parents over children, and the natural influence of wise, able, successful men and women. Workers formed fraternal groups; these still exist, more than a thousand years old...

All these are methods of using [human] energy flexibly, in mutual action. They are ways of controlling combined human energies without restricting individual freedom... There must have been many methods of controlling by mutual consent, all the activities of that busy civilization spanning three continents with trade, discovering and increasing and applying scientific knowledge, creating and distributing an unprecedented wealth of goods and of knowledge, literature, art, architecture - constantly improving all living conditions.

There was no Authority. There was no state. There was no Church."

The third attempt to achieve a free society, Rose Wilder Lane describes, is the American Revolution: "What actually occurred, when men could act freely was a terrific outburst of human energy, changing all life-values, and utterly transforming the material world." An article in the June 1991 issue of The Connector describes the impact of the American Revolution:

"The Revolutionary War gave Americans something new under the sun, something that no other people throughout all of history had ever enjoyed before, with the singular exception of the ancient Israelites... Up to the American Revolution there had been only two classes of people in the world, Rulers and Slaves, Kings and Subjects, and no man or group of men had ever been able to break that mold or to change that balance of power.

That all changed with the American Revolution and for the very first time the mold was broken and the balance of power shifted. With the defeat of King George our Founding Fathers gave us a very unique Constitution which severely limited the powers of government and then added a Bill of Rights which, literally, made every man a King and free to exercise, without undue restraint, his natural talents and abilities to the fullest extent possible.

This unlimited and free exercise of personal rights and abilities resulted in what is now called the Free Enterprise system of economy. Shortly after it went into effect a virtual explosion of prosperity followed. And this prosperity, in turn, created a new class of people on planet earth which we now know as the Middle Class. For the first time man had managed to free himself from the shackles of serving other men who had kept him in bondage for thousands of years.

This cumulative effect of exercise of personal rights and abilities, free enterprise economy, prosperity and the rise of the Middle Class produced a... New Nation... that in the span of just one generation... became the crown gem of all the nations in the world. We want to point out here so it will not go unnoticed, that there have been thousands of

fierce revolutions throughout all of history but not one of those revolutions produced a nation such as ours and we must ask ourselves why? Part of the answer is that those revolutions only put new faces in the seats of power but never gave men the opportunity to freely exercise their God-given rights and abilities. The American Revolution went the extra mile by making every man a King and as long as he had respect for the rights and property of all other men within that system of law agreed upon, there were no limits to how far he could spread his wings."

In his famous essay published in 1844, *The Right to Ignore the State*, Herbert Spencer wrote:
"It is a mistake to assume that government must necessarily last forever. The institution marks a certain stage of civilization - is natural to a particular phase of human development. It is not essential, but incidental. As amongst the Bushmen we find a state antecedent to government, so may there be one in which it shall have become extinct... The once universal despotism was but a manifestation of the extreme necessity of restraint. Feudalism, serfdom, slavery, all tyrannical institutions, are merely the most vigorous kind of rule, springing out of, and necessary to, a bad state of man. The progress from these is in all cases the same - less government... Thus, as civilization advances, does government decay. To the bad it is essential; to the good, not. It is the check which national wickedness makes to itself, and exists only to the same degree. Its continuance is proof of still-existing barbarism."

THE GROWTH OF BUREAUCRACY

Imagine a new kind of organism. It is the uncontested owner of a large territory with a hundred million slaves. All the organism does is cause problems. However, the slaves believe that the organism has the magical powers to solve all problems. They further believe that the more they feed the organism, the more problems it will solve. The organism feels better, the fatter it gets. In fact, its happiness is geometrically proportional to the quantity it consumes. Of course, the organism has no competition in its territory and the slaves may not feed any other organism. Guess how large the organism grows - and what it might give birth to?

In *America by the Throat: The Stranglehold of Federal Bureaucracy*, George Roche writes:
"The U.S. Office of Education was a tiny, fact-finding body in 1939 when it was incorporated into a new, larger bureau called the Federal Security Agency. Few remember what the FSA was, but everyone is thoroughly familiar with what it became. After fourteen years, the FSA was promoted to the cabinet and changed its title to the U.S. Department of Health, Education and Welfare. It began life with a budget of about $4 billion. After another twenty-six years, its budget now approaching $200 billion a year, HEW was seen to be great with child. And like some colossal whale calving, it was delivered of a whole new Department of Education. In forty years of gestation, the tiny education bureau had grown into a cabinet department with *152 offices* of its own and a budget of $12 billion. Its compound growth rate for the period must have outstripped a Ponzi game...

Bureaus... do not operate in the world of **doing things** with concrete purpose and clear goals. Their only purpose is to be what the reigning politicians say they should be, and move as far as they can up toward the fat end of the public trough."

Roche goes on to describe the reasons for bureaucratic growth:

- Greed. "To get a fat salary for doing nothing. To live off people."
- The "license to steal that is the state," coupled with greed. "Greed armed with a gun."
- Bureau bosses are paid, and their agencies funded, in relation to the number of bureaucrats they cultivate.
- The self-interest of the bureaucrats.
- The self-interest and the power of the state depend on its most pervasive reach and controls over society.
- "Drug addiction theory of bureaucracy." Every intervention ("fix") causes more problems, resulting in outcries for more interventions ("fixes").
- Some people resist the interventions. The bureaucrats use this as justification to expand their size and power in order to deal with the dissidents.
- Roche's first law of bureaucratic growth: "The supply of human misery will rise to meet the demand." He argues that "bureaucratic spending to "solve" any given social problem in truth represents dollar demand for more of just that problem... If Congress adjusts the qualifications for welfare - free money - potential recipients will adjust their lives to qualify."
- Roche's second law of bureaucratic growth: "The size of the bureaucracy increases indirect proportion to the additional misery it creates." He explains: "... State agencies can consume faster than we can produce. Never in sixty centuries of State history can I find a single exception to this... [I]n the State system, bureaucracy multiplies geometrically while the resources needed to support it, from the productive economy, grow only arithmetically. Political action creates an ever-increasing demand for bureaucratic intervention, which causes damage faster than society can repair it. Never knowing when to stop, the bureaucratic power continues to expand its interventions until society itself collapses."

THE MOST BASIC ARGUMENT AGAINST GOVERNMENT

People often debate or argue about the "role of government." But there is a basic argument that is almost always overlooked. It is a very simple argument. It goes like this:

- If you examine anything being "done by government," you will find human beings doing whatever is being done. They may also use equipment and machinery, but the most important work is being done by individual human beings. If you go to a school to examine it, you will not find any "government" that runs the school. You will find a principal, a number of administrative people, and several teachers - all individual human beings. No matter what government monopoly you examine, for example a police station, you will find that the important work is being done by individual human beings. If you visit a military installation, or a court, or a jail, or a veterans hospital, or a road being built, you will find individual human beings doing the work.
- The fact that these human beings call themselves "government," does not imbue them with magical powers to do their jobs better than those individuals who do not call themselves "government."
- Furthermore, the fact that certain individuals organize themselves into an institution called "government," does not imbue them with magical powers to do

their jobs better than those individuals who do not organize themselves into an institution called "government."
- In general, people who don't call themselves "government," can do anything humans can do, at least as well as people who call themselves "government."

  Is there any evidence that just because people call themselves "government," or they organize themselves into an institution called "government," they can do their jobs better?

IDOLATRY

The dictionary defines "idol" as:

- A representation or symbol of worship;
- A false god;
- A pretender or impostor;
- An object of passionate devotion;
- A false conception or fallacy.

Assemble yourselves and come together, draw near, you survivors of the nations! They have no knowledge - those who carry about their wooden idols, and keep on praying to a god that cannot save.
Isaiah 45, verse 20

An idolater is a worshipper of idols. Idolatry is the phenomenon of worshipping idols. What do we call the belief in the "magical power" of government? What about the belief that because people call themselves "government" - or they organize themselves into an institution called "government" - therefore they have "magical powers" to perform miracles? Superstition, perhaps?

In *Parliament of Whores*, P.J. O'Rourke writes:
"We treat the president of the United States with awe. We impute to him remarkable powers. We divine things by his smallest gestures. We believe he has the capacity to destroy the very earth, and - by vigorous perusal of sound economic policy - to make the land fruitful and all our endeavors prosperous. We beseech him for aid and comfort in our every distress and believe him capable of granting any boon or favor.

The type is recognizable to even a casual student of mythology. The president is not an ordinary politician trying to conduct the affairs of state as best he can. He is a divine priest-king. And we Americans worship our state avatar devoutly. That is, we do until he shows any sign of weakness, and disability, as it were. Sir James Frazer, in *The Golden Bough*, said: "Primitive peoples... believe that their safety and even that of the world is bound up with the life of one of these god-men... Naturally, therefore, they take the utmost care of his life... But no amount of care and precaution will prevent the man-god from growing old and feeble... There is only one way of averting these dangers. The man-god must be killed." Thus in our brief national history we have shot four of our presidents, worried five of them to death, impeached one and hounded another out of office. And when all else fails, we hold an election and assassinate their character."

WE NEED PLANNING, COORDINATION, AND MANAGING

Certain "communal" activities need to be performed. For example, in a city certain things need to planned, coordinated, and managed. If you go to any city, you will find some human beings doing just this. They may use computers and other equipment, but the essential planning, coordination, and managing is always done by human beings. If you visit a large company, you will find the same thing. We absolutely do need planning, coordination, and managing. We have it. People do it.

DO WE ALSO NEED COERCION, VIOLENCE, AND MONOPOLIES?

Generally, the people who call themselves "government" operate on a different basis from that of the people who don't call themselves "government." The following assumptions seem to underlie the behavior of the people who call themselves "government":

- We are the only ones qualified to do the things we do; therefore we must have a monopoly to do the things we do and no one else may do them.
- In particular, we must be the only ones who have a monopoly on legalized violence.
- Because we are so highly qualified, we can't persuade people to do what we want; therefore we must use coercion, violence, and armed police to force them to follow our orders.
- Because we are so highly qualified, we can't persuade people to pay for our wonderful services; therefore we must use coercion, violence, and armed police to force them to pay.
- Because we do our jobs so well, we must use coercion, violence, and armed police to force people to not compete with us.
- Some of our friends (who don't call themselves "government") are uniquely qualified to do the things they do (like doctors and other special-interest groups); therefore we grant them monopolies (licences), so they don't have to compete with unqualified quacks in a free market. Guess what this will do to medical costs - and the license fees and campaign contributions we'll be able to collect!

BUT WHAT ABOUT NATIONAL DEFENSE, POLICE, COURTS, AND PRISONS?

In our present world of violent limitation we are very restricted in the range of solutions we are stuck with. In a free market an infinite number of potential solutions become available. We would be free to experiment with a wide variety of solutions. There would be competition between solutions. People who operate in the economic mode tend to solve problems.

David Friedman, son of Nobel economics laureate Milton Friedman, has written a superb book, *The Machinery of Freedom: Guide to a Radical Capitalism*, which includes a chapter, "National Defense: The Hard Problem." There are basically two classes of functions the people called "government" perform - those we can eliminate today, and those we can eliminate tomorrow. National defense is in the latter class. David Friedman provides several suggestions for how national defense might be handled in a free society.

The following possibility is based on a suggestion from my friend Neil Steyskal: Often, when people think about national defense, they think in terms of defending against an invading army or against nuclear attack. Imagine that instead we think in terms of "defending against" the top political and military chiefs of any nation with a threatening military force. The theme of such a defense system is, "Anything military you do that threatens our security may result in personal destruction and/or death of your top banking, political, and military chiefs, their families, and their homes." The defense system is totally aimed at the banking, political, and military bosses. I'm sure someone with military, technological, and intelligence savvy could figure out how such a defense system could be set up for less than one percent of the current U.S. military budget. Of course, in a world of governments such a defense system is unthinkable - the first people to get killed would be the organizers of war.

Let me repeat the fundamental I have expounded: "government" is people; what they do is being done by people; these people don't have magical powers; other people can also do what "government" people do. Once you grasp this fundamental, you can open your mind to an unlimited range of possibilities. We already have private police in the form of security companies, because government police protection is insufficient. Common law courts developed without the "help" of government. And people don't have to call themselves "government" in order to build and operate prisons.

Robert Axelrod, Professor of Political Science and Public Policy at the University of Michigan, has written a groundbreaking book, *The Evolution of Cooperation*. On the dust cover is written:
"This pathbreaking and provocative work provides a bold answer to one of the oldest and most important questions human beings face: How can cooperation emerge among self-seeking individuals when there is no central authority to police their actions? It is a question that has troubled philosophers and statesmen for hundreds of years; its importance has never been greater than in today's world of nuclear weapons."

SPONTANEOUS LAW AND ORDER

Common law is an example of a legal system, including courts, that developed spontaneously. In *Law, Legislation and Liberty*, Nobel laureate Friedrich A. Hayek makes the distinction between "cosmos" and "taxis." Cosmos is a spontaneous order like language. Nobody sat down and designed English; it developed spontaneously over the centuries. A language can be regarded as an example of Cosmos. A crystal is another.

A skyscraper is a designed order or taxis. So are an automobile, a football team, and the U.S. Constitution. These are all orders designed by humans. For certain purposes we need designed orders; for others, spontaneous. Government is an attempt to impose a designed order through violence.

A society can be an example of cosmos. Common sense customs develop spontaneously - as did common law. A clever observer notices that certain behaviors work and others don't. So he formulates "Ten Commandments," which say, "don't do this and don't do that, because it doesn't work." Nobody needs to design a punishment system, because "nature automatically punishes" transgressors in the form of poor or negative results.

In *Government Anarchy and the POGONOGO Alternative*, Theodore Becker, professor of political science at the University of Hawaii, wrote:
"What anarchists admire is the antithesis of "government of law and not of men." They seek self-rule of men without externally imposed law and its cumbersome equipment of promulgation and execution. They entertain different assumptions about the political nature of man, whether in the state of nature or in the state of Vermont. They believe that if men were left alone to make up their own rules as they went along, according to their own ideas of what's right, society would be better off.

I was particularly intrigued by a comment of an American chief of police after his experience as an observer at the Woodstock Rock Festival in the summer of 1969. Chief Joseph Kimble, who has since been banished from the Beverley Hills Police Department, was astonished that over four hundred thousand young people could overpopulate a small area under terribly adverse weather and space conditions and get along so well, producing negligible violence and minor friction.

At Woodstock nearly half a million persons managed to simulate an urban slum, yet perform all animal functions happily - despite the near-absence of visible police power. As a matter of fact, the uniform of the token police force there was a red blazer, with no badge of authority except the Woodstock symbol: a dove and a guitar. Kimble emerged with some fresh ideas on the possibility that multitudes of people could police themselves with little structure akin to that we call police departments.

Was the Woodstock Nation a group of people living in anarchy [without having a ruler]? Yes. It was a gathering of people in large numbers who were determined to act in concert without regard to stone tablets, yellowed parchments, or rigid rulebooks."

At this point the "basic argument" is worth repeating:

- If you examine anything being "done by government," you will find human beings doing whatever is being done. They may also use equipment and machinery, but the most important work is being done by individual human beings. If you go to a school to examine it, you will not find any "government" that runs the school. You will find a principal, a number of administrative people, and several teachers - all individual human beings. No matter what government monopoly you examine, for example a police station, you will find that the important work is being done by individual human beings. If you visit a military installation, or a court, or a jail, or a veterans hospital, or a road being built, you will find individual human beings doing the work.
- The fact that these human beings call themselves "government," does not imbue them with magical powers to do their jobs better than those individuals who do not call themselves "government."
- Furthermore, the fact that certain individuals organize themselves into an institution called "government," does not imbue them with magical powers to do their jobs better than those individuals who do not organize themselves into an institution called "government."
- In general, people who don't call themselves "government," can do anything humans can do, at least as well as people who call themselves "government."

Is there any evidence that just because people call themselves "government," or they organize themselves into an institution called "government," they can do their jobs better? P.J. O'Rourke concludes his book *Parliament of Whores* as follows:

"... Authority has always attracted the lowest elements in the human race. All through history mankind has been bullied by scum. Those who lord it over their fellows and toss commands in every direction and would boss the grass in the meadow about which way to bend in the wind are the most depraved kind of prostitutes. They will submit to any indignity, perform any vile act, do anything to achieve power. ... Every government is a parliament of whores. [We pay them to get screwed?]

The trouble is, in a democracy the whores are us."

The General Theory of Tax Avoidance

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Abstract:
This paper outlines a general set of principles for tax avoidance. Most of at least the common tax avoidance schemes can be reinterpreted as making use of one or more of these principles. Four such methods would enable the astute taxpayer to eliminate all taxation on capital income. The fact that the tax system raises revenue is attributed to lack of astuteness of the taxpayer and/or lack of perfection of the capital market. Accordingly, models which attempt to analyze the effects of taxation assuming rational, maximizing taxpayers working within a perfect capital market may give misleading results.

A full analysis of tax avoidance cannot be conducted within a partial

equilibrium model; transactions which reduce one individual's tax liability may at the same time increase another's. We delineate tax avoidance schemes which reduce the aggregate tax liabilities of the participants. Much of the "general equilibrium" gain from tax avoidance arises from differences in tax rates, both across individuals and across classes of income. Our analysis is shown to have implications both for patterns of ownership of assets and the timing of transfers.

Adam Smith's theory of tax incidence: an interpretation of his natural-price system

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Abstract

Ricardo criticised Smith's statement that taxes levied on raw produce, necessities, wages, and profits would fail on rent. Ricardo thought that these taxes would fail on profits. This paper examines Smith's theoty of tax incidence in a Ricardo-Sraffa system of price determination. Consequently, the difference between Smith and Ricardo is attributed to two facts: (1) that Smith's system contains rent as an endogenous variable, giving the rate of profits exogenously; and (2), that Ricardo's system does not contain rent, making the rate of profits endogenous.

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History of tax

Taxation has been around in various forms for a very long time, dating back to the Romans. Notable events in history linked to tax include Lady Godiva's ride through the streets of Coventry in the 11th century in a plea for her husband to reduce taxes.

In the UK, the first instance of taxation being deducted out of a person's income before they had even received the money (called being deducted at source) happened in 1512. It was in 1803 that the schedules of income tax were introduced and they have been largely unchanged ever since.

1798 Prime minister, William Pitt the Younger, announced income tax to fund the Napoleonic wars. This was despite his belief that income tax was repugnant to the customs and manners of a nation.

1799 Income tax introduced to all of Great Britain (but not Ireland) The rate was 10% on a person's total income above £60 per year. It was to be paid in 6 equal instalments.

1803 Henry Addington, who later became Viscount Sidmouth, introduces taxation at source as well as a system of Schedules

(explained later). Addington's rate of tax was half that of William Pitt's but the changes Addington introduced ensured that revenue rose by half and the number of people paying tax doubled.

1806 The taxation rate rose to 10%, the original level it was introduced at by William Pitt.

1816 All tax records were burned after income tax was repealed a year after the Battle of Waterloo. The critics of income tax won the day but what they didn't know was that duplicates had been sent to the King's Remembrancer.

1842 Income tax is brought back by conservative Prime Minister Sir Robert Peel. He had opposed income tax but faced with a growing deficit, he had no choice but to spring a surprise and re-introduce income tax. Peel decided to only tax those with incomes greater than £150. This meant that the less wealthy benefited.

1849 The Board of Excise was added to the existing Board of Taxes and Board of Stamps to create the new Board of Inland Revenue. The Board of Excise moved away from the Board of Inland Revenue in 1909 (to the Board of Customs).

1874 Although it was widely thought that income tax would be removed when Disraeli was returned as Prime Minister, income tax stayed. This was despite the fact that income tax contributed only £6 million to the Government revenue of £77 million. Most of the population were exempt.

1907 Herbert Asquith, the chancellor, introduces a number of different income and investment taxes. One of these was the concept of differentiation, taxing less on earnings than on investments.

1918 The standard rate of tax increased to 30%, bringing in £257 million on top of the £36 million from the super-tax. In addition, there were other taxes such as Excess Profits Duty. In all, the taxes collected amounted to more than £580 million, which was 17 times the amount in 1905.

1920 A Royal Commission was set-up to look into income tax and the super tax. It concluded that they should remain.

1930 With a population of 45 million, 10 million were taxpayers.

1939 The standard rate of income tax is 29% with a surtax of 41% for incomes over £50,000. Ten million people were taxpayers. The amount raised was £400 million.

1945 Due to a rapid rise in the number of taxpayers, the threshold at which taxpayers pay tax is lowered and the rates of tax increased. This is done to pay for the war effort.

1944 The Pay tax As You Earn system (PAYE), is introduced. This replaced annual or twice yearly collections. Tax was deducted by employers and when an employee left an employer, they

were given a P45 which had on it their code number, income to date and tax paid to date. The P45 was given to their new employer. The scheme had been piloted by Sir Kingsley Wood but on the day it was to be announced, he died. By the end of January 1944, 15 million people earning £100 a year or more, received notices telling them their code number.

1965 Capital gains tax is made part of the tax system by James Callaghan, as is corporation tax. James Callaghan, later to become Prime Minster, had worked for the Inland Revenue.

1973 Value Added Tax, VAT is introduced. The super tax (surtax) as introduced in 1909, was removed in this year but replaced by higher rates of income tax for those with high incomes.

1992 The Queen elects to pay tax on her income in a move designed to bring her closer to the people.

1996 The introduction of Self-Assessment. It is designed for people with more complex tax affairs including those who are self-employed, business partners, company directors and those paying tax at higher rates. It is not a new tax but a new system. More than £25 million is budgeted for the advertising and public awareness campaign for Self-Assessment.

1998 The bicentenary of income tax in the UK.

Timeline of Chancellors

1783-1801	William Pitt
1801-1804	Henry Addington
1804-1806	William Pitt
1806-1807	Henry Petty
1807-1812	Spencer Perceval
1812-1823	Nicholas Vansittart
1841-1846	Henry Goulburn
1846-1852	Charles Wood
1852	Benjamin Disraeli
1852-1855	William Gladstone
1855-1858	George Lewis
1858-1859	Benjamin Disraeli
1859-1866	William Gladstone
1866-1868	Benjamin Disraeli
1868	George Hunt
1868-1873	Robert Lowe
1873-1874	William Gladstone

1874-1880	Stafford Northcote
1880-1882	William Gladstone
1882-1885	Hugh Childers
1885-1886	Michael Hicks-Beach
1886	William Harcourt
1886-1887	Randolph Churchill
1887-1892	George Goschen
1892-1895	William Harcourt
1895-1902	Michael Hicks-Beach
1902-1903	Charles Ritchie
1903-1905	Austen Chamberlain
1908-1915	David Lloyd George
1915-1916	Reginald McKenna
1916-1919	Bonar Law
1919-1921	Austen Chamberlain
1921-1922	Robert Horne
1922-1923	Stanley Baldwin
1923-1924	Neville Chamberlain
1924	Philip Snowden
1924-1929	Winston Churchill
1929-1931	Philip Snowden
1931-1937	Neville Chamberlain
1937-1940	John Simon
1940-1943	Kingsley Wood
1943-1945	John Anderson
1945-1947	Hugh Dalton
1947-1950	Stafford Cripps
1950-1951	Hugh Gaitskell
1951-1955	Rab Butler
1955-1957	Harold Macmillan
1957-1958	Peter Thorneycroft
1958-1960	Derrick Heathcoat-Amory
1960-1962	John Selwyn Lloyd
1962-1964	Reginald Maudling
1964-1967	James Callaghan
1967-1970	Roy Jenkins
1970	Ian Macleod
1970-1974	Anthony Barber
1974-1979	Dennis Healey
1979-1983	Geoffrey Howe
1983-1989	Nigel Lawson

1989-1990	John Major
1990-1993	Norman Lamont
1993-1997	Kenneth Clarke
1997 onwards	Gordon Brown

Did you know...

You may be interested in the following tax facts.

A temporary tax?

Income tax is still to this day, a temporary tax. It expires on 5 April of each year and Parliament has to reapply it by the annual Finance Act. For up to four months until the Finance Act becomes law again, the Provisional Collection of Taxes Act (1913) ensures that taxes can still be collected.

Taxation - a big business

The Inland Revenue produces more than 12.5 million leaflets a year making up 160 titles. Nine million people are affected by self assessment. The Inland Revenue employs more than 50,000 people but many times that number work in the industry, e.g. tax advisers, accountants, solicitors, etc.

Today's taxes

Many people focus on what the top rate of tax is. Whatever income tax you pay, consider that - out of your already taxed income - you are paying additional tax on tobacco, fuel, alcohol, cars (road fund and VAT), VAT (payable on most items that you buy ... including many of the items already listed!)

Despite all this, you might be surprised to read that the UK has one of the lowest overall tax rates in Europe.

A brief history of tax

Jan 27th 2000
From *The Economist* print edition

“NO TAXATION without representation.” The slogan of the American revolution has long been a rallying cry for taxpayers and tax evaders alike—though not always with such dramatic consequences. Arguably, the struggle to tax people in ways they find acceptable has been the main force shaping the modern nation-state. But are tax policies designed when the nation-state was all-powerful still appropriate now that globalisation, spurred on by the Internet, is rapidly eroding national borders?

Prostitution may be the oldest profession, but tax collection was surely not far behind. The Bible records that Jesus offered his views on a tax matter, and converted a prominent taxman. In its early days taxation did not always involve handing over money. The ancient Chinese paid with pressed tea, and Jivaro tribesmen in the Amazon region stumped up shrunken heads. As the price of their citizenship, ancient Greeks and Romans could be called on to serve as soldiers, and had to supply their own weapons—a practice that was still going strong in feudal Europe. As Ferdinand Grapperhaus recounts in “Tax Tales” (International Bureau of Fiscal Documentation, Amsterdam, 1998), the origins of modern taxation can be traced to wealthy subjects paying money to their king in lieu of military service.

The other early source of tax revenue was trade, with tolls and customs duties being collected from travelling merchants. The big advantage of these taxes was that they fell mostly on visitors rather than residents. One of the earliest taxes imposed by England’s Parliament, in the 13th century, was “tonnage and poundage” on wine, wool and leather, targeted at Italian merchants. Sometimes rulers went a little over the top. Excessive taxation was one reason why King Charles I of England lost his head. Many of those guillotined during the French Revolution of 1789 were much-resented private tax collectors. And the Boston Tea Party was a protest by American patriots against the tea tax imposed by their British rulers.

Income tax, the biggest source of government funds today, is a relatively recent invention, probably because the notion of annual income is itself a modern concept. Governments preferred to tax things that were easy to measure and therefore to calculate liability on. That is why early taxes concentrated on tangible items such as land and property, physical goods, commodities and ships, or the number of windows or fireplaces in a building. The first income tax was levied in 1797 by the Dutch Batavian Republic. Britain followed suit in 1799, and Prussia in 1808. Like most new taxes, these imposts were first introduced as temporary measures to finance war efforts. After the European powers had made peace in Vienna in 1815, Henry Addington, the British prime minister of the day, swore that an income tax would never be imposed again. But in 1842 the British government revived the tax.

What stands out about the 20th century—and particularly its second half—is that governments around the world have been taking a growing share of their countries’ national income in tax, mainly to pay for ever more expensive defence efforts and for a modern welfare state. Taxes on consumption, such as the sales tax that is a big source of revenue for America’s state and local governments, and the value-added tax on goods and services in Europe, have become increasingly important.

Big differences between countries remain in the overall level of tax. America’s tax revenues amount to around one-third of its GDP, whereas Sweden’s are closer to half. There are also big differences in the preferred methods of collecting it, the rates at which it is levied and the definition of the “tax base” to which those rates are applied, as well as the division of responsibility for taxation between levels of government.

Global economy, national taxes

The increasing globalisation of economies in the 20th century was accompanied by a rare outbreak of internationalism by the tax authorities. Many countries chose to tax their

citizens—individual or corporate—on their global income, whether or not they had already paid their due on some of it abroad.

The League of Nations, the forerunner to the United Nations, in 1921 commissioned a report by financial experts who concluded that this practice of "double taxation" interfered with "economic intercourse and...the free flow of capital". It suggested rules for determining when tax should be paid to the country in which the income is generated, and when to the taxpayer's country of residence. It drafted a model treaty (now updated by the OECD) that spawned many bilateral agreements. Initially intended to stop income being taxed twice, these bilateral treaties opened the way for multinational companies to avoid tax on their profits altogether by setting up in business where taxes were lowest. Combined with greater mobility of capital, this new flexibility encouraged tax competition between countries.

November 5, 2004

Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?

by Stephen J. Entin

Center for Data Analysis Report #04-12

I. Introduction

Who pays the income tax, the payroll tax, the estate and gift taxes? Who bears the burden of the gasoline and tobacco taxes? If Congress were to raise this tax rate, or lower that tax deduction, who would gain and who would lose? The outcomes of the political battles over changes in the tax system often hinge on the answers to such questions.

To demonstrate who pays current taxes or who would be the winners and losers from a tax change, the Joint Committee on Taxation of the Congress (JCT) produces "burden tables" showing how much money everyone sends, or would send, to the Treasury. Winners and losers are grouped by their adjusted gross income class, and the distributional impacts of a tax, or a tax change, are displayed. Burden tables are also prepared on occasion by the Treasury and the Congressional Budget Office, as well as private research groups, using sometimes similar, sometimes different assumptions and methods of display (such as by "income quintile"). The burden tables are supposed to shed light on the tax system or the effect of a new tax proposal, but they often do more to obfuscate than to illuminate the facts.

The true measure of the burden of a tax is the change in people's economic situations as a result of the tax. The changes should be measured as the effects on everyone's net-of-tax income after all economic adjustments have run their courses. The burden measure should include not only changes in people's after-tax incomes in a single year, but the lifetime consequences of the tax change as well. Unfortunately, policymakers are not presented with this type of comprehensive information on the true burden of taxation and must make policy judgments based on incomplete and misleading statistics.

One cannot tell the true burden of a tax just by looking at where or on whom it is initially imposed, or at what it is called. Taxes affect taxpayers' behavior, triggering economic changes that regularly shift some or even the entire economic burden of a tax to other parties, and alter total output and incomes. Taxes reduce and distort the mix of what people are willing to produce in their roles as workers, savers, and investors. Taxes increase what these producers seek to charge for their services or products. Changes in the prices and quantities of output in turn affect people in their roles as consumers when they try to spend their incomes. The lost output and other consequences of taxation impose additional costs on the taxpayers that are not reflected in the mere dollar amounts of the tax collections.

The Treasury put these problems well in its 1991 study on ending the double taxation of corporate income, writing that:

The economic burden of a tax, however, frequently does not rest with the person or business who has the statutory liability for paying the tax to the government. This burden, or incidence, of a tax refers to the change in real incomes that results from the imposition of a change in a tax.[1]

These ultimate effects and burdens of taxation are explored in a corner of the economic literature, but they are nowhere to be found in the "burden tables" that are prepared by the government agencies and scrutinized in tax debates. Instead, the burden tables are constructed using crude assumptions and oversimplified rules of thumb to assign various taxes to suppliers of labor or capital, or to consumers. These assumptions and rules are often adopted more for ease of computation than for economic accuracy. In fact, no burden table ever published has been based on how taxes truly affect incomes.

What price do we pay for glossing over the true economic burden of a tax? Failure to understand and take account of the economic consequences of taxation leads to a gross misrepresentation of the distribution of the tax burden. This in turn has led to a tax system that, while supposedly promoting social justice, is actually harmful to lower-income workers and savers, as well as damaging to the population as a whole. A better understanding of the economic consequences and real burdens of taxation is indispensable to achieving an optimal tax system—one that minimizes the economic and social damage associated with financing government outlays.

A better understanding of the economic consequences of taxation would also benefit the Treasury and the Congress as they plan the federal budget and contemplate changes in the tax system. It should lead to more accurate revenue forecasting. It might also encourage the adoption of tax bills that are more concerned with increasing national and individual income and less concerned with redistributing the existing level of national product.

This paper will discuss the economic consequences of taxation and the factors that influence where the burden of various taxes really falls. It will review some of the discussions in the economic literature. Finally, it will suggest that a shift to a markedly different type of tax system would benefit all players in the economy.

II. Sorting Out Some Terminology

The terms "tax incidence" and "tax burden" are thrown around rather loosely in the economic literature and in the popular press. Some authors use them interchangeably for any of several concepts of the effect of a tax. Some authors use them for separate concepts, but different authors do not agree as to which term means which concept. This paper will seek to distinguish clearly among several distinct concepts of "incidence" of a tax and to reserve a single term for each. We define three concepts:

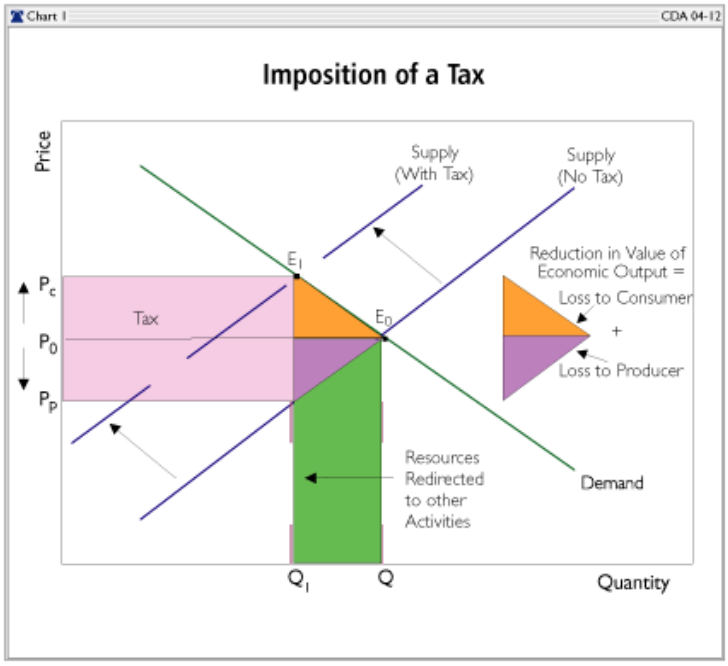
- The "statutory" or "legal obligation," which refers to the person on whom the law says that the tax obligation falls (which may bear little relationship to who actually feels the pain);[2]
- The "initial economic incidence" (or "incidence" for short), which is how the economic supply and demand conditions *in the market for the taxed product or service or factor of production* allocate the tax among suppliers and consumers of the taxed item (which allocation may be different in the short run and the long run); and
- The "ultimate economic burden" (or "burden" for short), which measures the changes in people's after-tax incomes after all the economic adjustments to the tax have occurred *across all affected markets* as consumption behavior, resource use, and incomes shift to their new patterns.

These definitions distinguish between the terms "incidence" and "burden." "Incidence" is defined as the partial own-market economic effects of the tax, which may also be thought of as partial equilibrium analysis. "Burden" is defined as the general equilibrium economic results involving all markets. When the paper quotes other sources that employ the terms differently, the reader must perform the required mental translation.[3]

III. The Simple Example of a Selective Excise Tax: Statutory Obligation, Initial Incidence, Ultimate Burden

Charting a Simple Excise Tax

Consider the imposition of a selective excise tax, such as the cigarette tax or the gasoline tax. (See Chart 1.) In the absence of the tax, supply would equal demand at the equilibrium point E0, with a unit price of P0 and a quantity of Q0 units.



Imposing a per unit tax of t = (Pc–Pp) drives a wedge between the price paid by the consumer (Pc) and the price received by the producer (Pp). As the gross price to the buyer is driven up, the quantity demanded shrinks (movement along the demand curve). As the net price received by the seller falls, less is supplied (movement along the supply curve). The quantity of output falls from its original value (Q0) to its new value (Q1). Market equilibrium shifts from E0 to E1.

Tax revenue is t x Q1 (the shaded area, unit tax times quantity). Note that the revenue is not equal to t times the original quantity of the product in the absence of the tax; it is t times the *reduced* output brought about by the tax. In usual parlance, the upper portion of the revenue rectangle, (Pc– P0) x Q1, is considered to be the share of the tax that falls on the consumer because he now pays a higher tax-inclusive price. The bottom portion of the rectangle, (P0–Pp) x Q1, is considered to be the share of the tax that falls on the producer in the form of a lower net-of-tax price and revenue received for selling the product.

The reduction in output deprives the consumer of the value he places on the lost output, the taller trapezoidal area under the demand curve between Q0 and Q1. The reduction in output frees up resources for other uses equal to the shorter trapezoidal area under the supply curve between Q0 and Q1. The shaded triangle between the supply and demand curves is the dead weight social cost of the tax, representing the excess value of the lost product over its resource cost, split between the consumer and the producer.

The imposition of the tax is sometimes illustrated as a backward shift in the supply curve (shifting the tax-inclusive supply curve to pass through point E1, labeled "supply with tax" in the diagram). This can be viewed as showing the tax to be a cost of calling forth the product. Alternatively, it is described as a representation of a tax imposed on the consumer, emphasizing the higher gross price paid as the result of

the tax. The tax may also be drawn as a backward shift in the demand curve, shifting it to pass through the point where price equals Pp and quantity equals Q1. This is sometimes described as illustrating a tax imposed on the producer, emphasizing the receipt by the producer of the lower net-of-tax price.

Whether the tax is *described* as being paid by the producer or by the consumer, the *outcome* is the same: The rise in the price to the buyer to Pc, the drop in the price to the seller to Pp, and the drop in production to Q1 are identical whichever view is taken and depend entirely on the rate of the tax and the slopes (elasticities) of the supply and demand curves. Elasticity will be discussed in greater detail below.

Statutory or Legal Obligation of an Excise Tax

Who pays a selective excise tax? The legal obligation to pay would depend on the wording of the statute. It might be called either a consumer-level tax (e.g., the gasoline excise tax, collected at the pump) or a producer-level tax (e.g., the alcohol and tobacco taxes, collected from manufacturers).

As the diagram shows, the distinction is economically meaningless and does not reflect the economic division of the tax burden. Consumers and producers are both affected to some degree, regardless of the statutory label. How they share the incidence of the tax depends entirely on their responsiveness to the price changes, the slopes of the supply and demand curves, not on whether the wording of the statute charges the consumer with the tax and it is merely collected by the seller and forwarded to the government, or whether the statute names the seller as being charged with the tax directly.

Economic Incidence of an Excise Tax

The initial economic incidence is properly calculated as partly falling on consumers, to the extent of the revenues they pay plus their share of the deadweight loss triangle, and partly falling on producers, to the extent of the revenues they pay plus their share of the deadweight loss. Producers are the workers who supply labor and the investors who supply capital to a business. What do we mean by saying that part of the excise tax falls on producers? When a tax is imposed on a final product, the reduction in demand for and output of the product in turn reduces the demand for the inputs used to produce the product, which reduces workers' wages and investors' returns on saving.

Note that most consumers are also workers and/ or suppliers of capital (unless they are living entirely on welfare or other transfer payments). The excise tax, insofar as consumers pay it or insofar as it leads them to reallocate their resources to second-best choices, reduces the quantity and value of what they can buy with an extra dollar of income. The tax devalues their earnings from labor or saving. That is, insofar as the tax is "passed forward" to consumers, it is ultimately a tax on their labor and capital income. All taxes are ultimately taxes on income, which is to say, on producers. An excise tax falls either on the labor and capital employed in the taxed industry or on the consumers, who happen to provide labor and capital services in other industries.

Incidence and Elasticity. How buyers and sellers share the initial incidence of a tax depends on their market behavior. The portion of the tax presumed to be paid by the buyer or the seller varies depending on the responsiveness of the demand for and the supply of the product or input as the price changes. In the chart, this is reflected in the steepness of the demand and supply curves.

"Elasticity" is the percent change in the quantity of a product (or factor of production —labor, capital, land, etc.) supplied or demanded divided by the percent change in its price (or wage or rate of return). For example, if people are easily discouraged from buying a particular product (or employing a particular factor) as its price rises, then that ratio will be high, the demand for the product (or for the factor) is said to be elastic, and the demand curve is rather flat. If people are unwilling to give up much of the product (or factor) even if the price rises sharply, the ratio will be low, the demand is said to be inelastic, and the demand curve is steep.

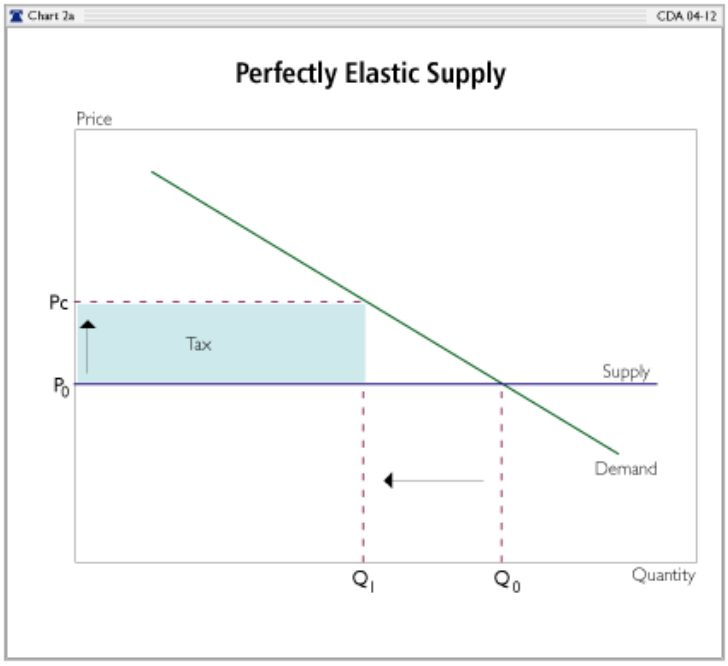
The elasticities of demand and supply tend to be greater in the long run than the short run. It may take some time for people fully to adapt to a tax change. For example, in the short run, a rise in the tax on gasoline may encourage people to drive their existing cars less by taking fewer trips, by car pooling, or by switching to public transportation. Longer-term, people may replace their existing cars with models that offer higher fuel economy or may move closer to their work. The long-run demand for gasoline should be more elastic than the short-run demand.

Four Extreme Cases of Elasticity. There are four extreme or limiting cases— not generally seen in the real world—that illustrate the concept of elasticity and its implications.

- *Perfectly Elastic Supply (Chart 2a)*. If a product is easily reproduced or obtained at the same cost per unit, no matter how many units are sought, then the supply curve is horizontal and the net-of-tax price is fixed at that marginal cost. (Example: the supply in a small town of a commodity sold nationally [say, Budweiser]). If the buyers in the town are willing to pay the market price, they can get a virtually unlimited supply [or at least all they can hold]. If they are not willing to pay that price, they will get none.) Any tax is borne by the consumer. Output or availability will fall if demand is price-sensitive.
- *Perfectly Elastic Demand (Chart 2b)*. If demand is perfectly elastic, any rise in the price would cause a collapse in consumption. (Example: the demand for beer at one out of 12 concession stands at a stadium. If one stand tries to charge more than the others, it will lose all its business to the other stands.) The demand curve is horizontal, and the market price is fixed. Any tax imposed (on that one beer outlet) will simply lower the net-of-tax price to the producer, who must bear the whole tax. Output will fall if supply is price-sensitive.
- *Perfectly Inelastic Supply (Chart 2c)*. If supply is perfectly inelastic, the same quantity of product must be offered regardless of the price. (Example: perishable strawberries at a farmers' market late in the day.) The supply curve is vertical. The price is fixed by demand (what consumers are willing to pay). Any tax imposed will result in a lower net-of-tax price to the seller, who must bear the tax. Output is unchanged. (The strawberries are a short-run

example. Repeated inability to sell the fruit will result in less being grown next season.)

- *Perfectly Inelastic Demand (Chart 2d)*. If demand is completely insensitive to price, people insist on the same quantity of output regardless of what must be paid. (Example: addictive drugs. Addicts in need of a fix will demand the drugs up to the full amount of their resources.) The demand curve is vertical, and any tax will be borne by the consumers. Output is unchanged. (Of course, this is tongue in cheek. A dealer in illegal drugs is no more likely to collect and remit a hypothetical sales tax than he is to report his illegal profits to the IRS under the income tax. Substituting a national sales tax for the income tax would not eliminate tax evasion in the underground economy.)



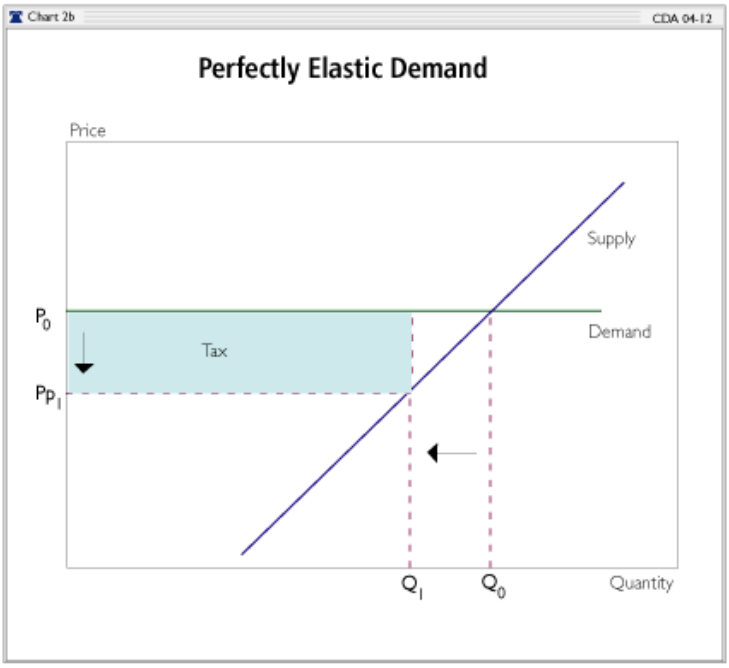


Chart 2b
CDA 04-12
Perfectly Elastic Demand
Price
Supply
P_0
Demand
Tax
Pp_1
Q_1
Q_0
Quantity

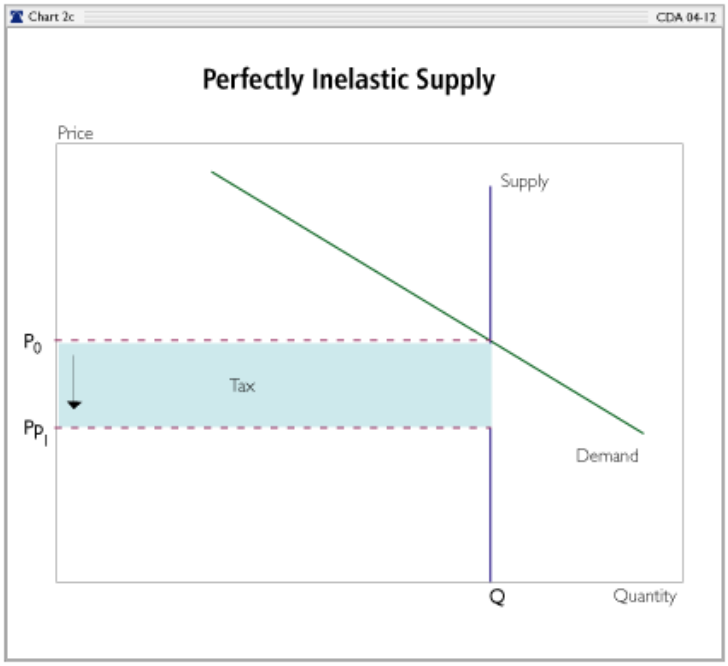
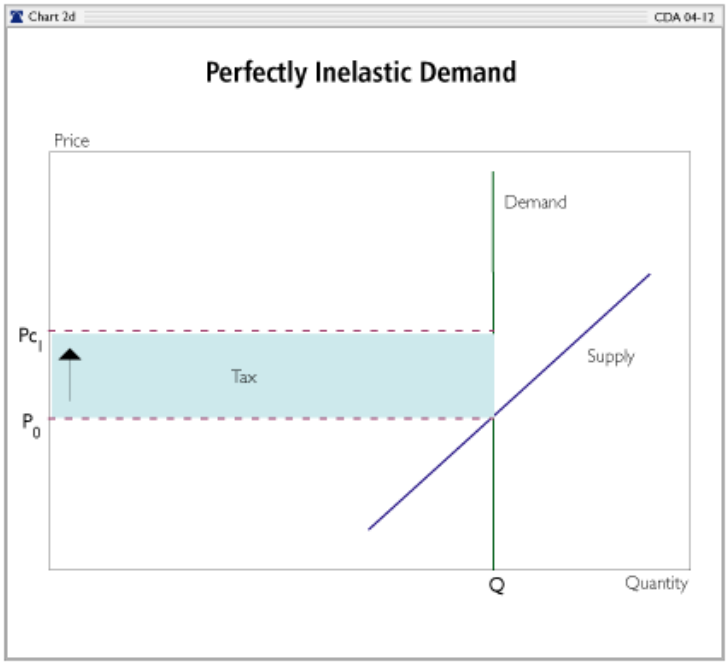


Chart 2c
CDA 04-12
Perfectly Inelastic Supply
Price
Supply
P_0
Tax
Pp_1
Demand
Q
Quantity



The Perfect Non-Distorting Tax Base? Politicians eagerly seek these last two situations of perfectly inelastic supply and demand in their quest for the perfect tax base. No matter how high they might push the tax on such a product, the tax base would not collapse and revenues would keep climbing. In particular, politicians like to believe that the demand curves for cigarettes, liquor, and gambling are perfectly inelastic. They are wrong, but they keep pushing tobacco and alcohol tax rates higher, hoping for a miracle. They also get stingy with the payout ratios on state-sponsored lotteries. In this case, it is those who buy lottery tickets who are hoping for a miracle. In theory, governments could reduce economic distortions and minimize dead weight losses by putting the highest tax rates on the products or inputs that are in most inelastic demand or supply.

The ultimate example of a non-distorting tax would be a head tax or poll tax that is owed just for being alive and is totally unrelated to any incremental earnings or the amount of one's economic activity. Such a tax, however, might not pass the "equity" test unless it could be shown that all parties would share in the resulting improvement in national output and income.

Economic Burden of an Excise Tax

The ultimate economic burden of an excise tax would be found by carrying the analysis one step further. It is not only the consumers and producers of the taxed product who are affected by the tax. Resources driven from the production of the taxed items must seek alternative employment and will generally earn lower returns in these second-best uses. They will compete with and affect resources in these other uses. For example, land taken out of the production of tobacco because of higher cigarette taxes may be used to produce vegetables instead, lowering the price of vegetables. Both the displaced tobacco farmers and the existing truck farmers

who now face added competition are injured, while consumers of vegetables benefit.

The impact of the tax may shift over time. A new tax on wine may simply hit the wineries initially, because their vines, fermenting vats, and bottling machinery are still in place and will earn more being used than being shut down if the reduced after-tax revenues at least cover the labor costs. Later, however, the vines may be dug up and the land shifted to other crops that now yield a higher return. The machinery may wear out and not be replaced. As supply falls, the excise tax will be shifted to consumers longer-term. They will have to pay more for a bottle of wine. They may switch some of their spending to other goods and services, affecting other industries.

Human capital may bear part of the cost. If a tax on wine causes a vineyard to convert to growing table grapes or avocados, the vineyard workers may be kept on to tend and pick the new crops; if their skills are transferable, they will face little damage. It would be different for the technical experts responsible for the fermenting, testing, and tasting of the wines; they may have no alternative use for these highly specialized skills, which become redundant. Such specialists who are forced into other occupations will lose the wage premium their skills commanded. The caves in which the wines were stored, and the slopes with microclimates peculiarly suited to wine production, will lose their advantage and some of the rent they commanded in wine production.

The need to consider these economy-wide and long-term ramifications, called "general equilibrium" analysis, is not a new idea in tax theory. Alfred Marshall's classic discussion of the incidence of taxation in his *Principles of Economics* is as valid today as it was roughly a hundred years ago. Taxes on inputs are borne largely by the suppliers of the inputs if those inputs have no good alternative uses (inelastic supply), but are borne largely by the consumers of the product if the inputs are readily shifted to other uses (elastic supply). A new tax imposed on existing capital will be borne by the capital in the short run but may discourage renewal of the capital stock as it wears out, causing the tax to be shifted to the consumers in the long run (and to any other immobile inputs that would have worked with the lost capital). A nationwide tax may impact producers and consumers of the product, but a local tax will simply drive the producers to move their inputs to another part of the country. In Marshall's words:

It is a general principle that if a tax impinges on anything used by one set of persons in the production of goods or services to be disposed of to other persons, the tax tends to check production. This tends to shift a large part of the burden of the tax forwards on to consumers, and a small part backwards on to those who supply the requirements of this set of producers. Similarly, a tax on the consumption of anything is shifted in a greater or less degree backwards on to its producer.

For instance, an unexpected and heavy tax upon printing would strike hard upon those engaged in the trade, for if they attempted to raise prices much, demand would fall off quickly: but the blow would bear unevenly on various classes engaged in the trade. Since printing machines and compositors cannot easily find employment out of the trade, the prices of printing machines and wages of compositors would be kept low for some time. On the other hand, the buildings and steam engines, the

porters, engineers, and clerks would not wait for their numbers to be adjusted by the slow process of natural decay to the diminished demand; some of them would be quickly at work in other trades, and very little of the burden would stay long on those of them who remained in the trade. A considerable part of the burden, again, would fall on subsidiary industries, such as those engaged in making paper and type; because the market for their products would be curtailed…. Authors and publishers [and] booksellers…would suffer a little….

[I]f the tax were only local, the compositors would migrate beyond its reach; and the owners of printing houses might bear a larger…proportionate share of the burden than those whose resources were more mobile….

Next, suppose the tax to be levied on printing presses instead of on printed matter. In that case, if the printers had no semi-obsolete presses which they were inclined to destroy or to leave idle, the tax would not strike at marginal production: it would not immediately affect the output of printing, nor therefore its price. It would merely intercept some of the earnings of the presses on the way to the owners, and lower the quasi-rents of the presses. But it would not affect the rate of net profits which was needed to induce people to invest fluid capital in presses: and therefore, as the old presses wore out, the tax would add to marginal expenses…. [T]he supply of printing would be curtailed; its price would rise: and new presses would be introduced only up to the margin at which they would be able…to pay the tax and yet yield normal profits on the outlay. When this stage had been reached the distribution of the burden of a tax upon presses would henceforth be nearly the same as that of a tax upon printing….[4]

Burden Tables Botch Excise Tax "Incidence" and "Burden"

Burden tables use the least meaningful of all the above concepts of incidence and burden to allocate the impact of excise taxes. Burden tables assume that all excise taxes, whether labeled consumers' or manufacturers' excise taxes, are paid entirely by the consumers of the products (as under the statutory obligation concept of a consumer-level tax). The "distribution" of the tax across income levels is calculated by taking the average amount spent on the product by people in various adjusted gross income classes times the tax rate. The tables ignore the split between producers and consumers that must occur in any market with normal elasticities. Furthermore, they look only at the revenues collected, t x Q1, and ignore the deadweight loss, so that, even ignoring the split, they do not measure the total initial incidence correctly.

An excise tax analyst at the JCT or Treasury will use the long-run elasticities of demand and supply for the taxed good to estimate the eventual change in consumption (the drop from Q0 to Q1) and will estimate the tax revenue that the Treasury will receive at the new, reduced level of consumption. In constructing a burden table, he will attribute all of the incidence of the tax to the consumers. However, the analyst will assume no loss in total output or efficiency for the economy as a whole, and no loss of revenue from other taxes, because he assumes that resources driven out of producing the taxed good find alternative employment at virtually unchanged earnings. He ignores any shifting of the economic burden to producers as resources are shifted to alternative, lower-paid uses. Burden table

analysis thus gets both the total and the distribution of excise taxes wrong except in the extreme case of a product in absolutely inelastic demand.

IV. Extending the Analysis: Income and Payroll Taxes on Capital and Labor

The same sort of diagram may be applied to any tax. The tax may be a general sales tax, or a payroll or personal income tax on wages or on capital income, or the corporate income tax. In the case of a tax on labor income, the price becomes the wage, and the quantity becomes hours worked or the level of employment or some other measure of the services of labor. In the case of capital services, the price becomes the rate of return on capital, and the quantity is the amount of capital services forthcoming from the stock of plant, equipment, structures, and land.

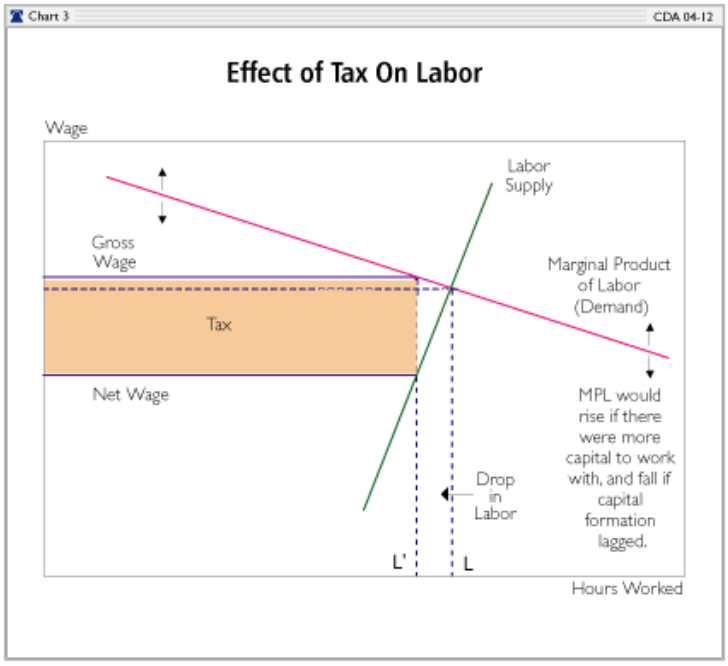
The demand for labor and capital reflects the value to the employer of using additional units of labor and capital. The added output obtained by employing one more worker or machine is the "marginal product of labor" or "marginal product of capital." The added physical output times the price it sells for (marginal value product) is the most that a firm will pay to hire an additional worker or pay for the services of an additional machine or building.

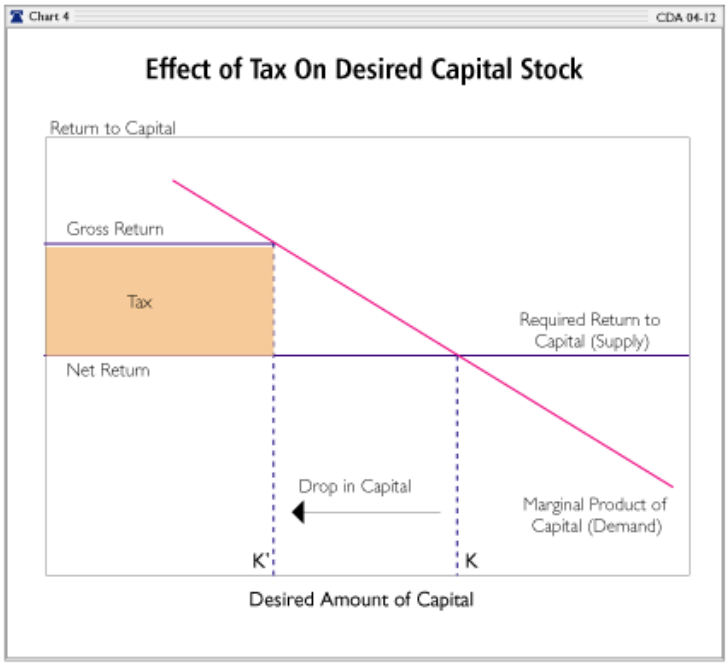
As more of any one factor is added, other factors held constant, output rises, but at a diminishing rate. This is the famous "law of diminishing returns." The gradual decline in the marginal products of labor or capital as more of one of them is employed is why the demand curves for the factors slope downward.

Charts 3 and 4 illustrate the supply and demand conditions generally assumed for broadly defined labor and capital inputs, respectively, and the different effects one might expect from taxing these factors.

Labor Market

The Supply of Labor. The supply of labor is rather inelastic. It was fashionable in the 1950s and 1960s to assert that the supply of labor was nearly perfectly inelastic with respect to the wage (or after-tax wage). That is, workers did not vary their labor supply very much in response to changes in the after-tax wage. The thinking was that adult males were the bulk of the workforce, and, as their families' sole breadwinners, they were very attached to the workforce. Furthermore, they were generally employees of corporations or other businesses that set their hours, giving them virtually no option but to work a 40-hour week unless there was overtime, which was typically mandatory, or they were willing to take on second jobs. With limited ability to vary their hours worked or participation in the workforce, such workers were assumed to bear any taxes imposed on labor, including the income tax and the entire payroll tax, both the employee and employer shares. This is the convention still used in burden tables.





Over time, most married women and many teenagers have entered the workforce, and a growing number of "retirees" hold part-time jobs. Many of these workers are less tightly "attached" to the workforce than prime-age males. Since the 1980s and 1990s, a larger portion of the workforce has become self-employed or is seeking to work part-time. These workers have far more flexibility to set their own hours and display a less rigid attachment to the workforce than adult males. Also, as two-earner couples have become the norm, men have had more opportunity to work less, courtesy of their wives' incomes. Although the men may have worked less as family

income rose, the couple may have worked more, taking both spouses' efforts together.

One should expect higher elasticities for upper-income workers, whose income and wealth give them added flexibility to alter their hours while maintaining a high living standard. Modern consensus estimates of labor force elasticity, while still low, are generally non-zero. For example, a survey of 65 labor economists produced estimates of the labor supply elasticity for men of 0.1 (mean estimate) and zero (median estimate). For women, the survey gave estimates of 0.45 (mean) and 0.3 (median).[5]

The Demand for Labor. The demand for labor is moderately elastic. Its large share of the national income makes it a major expense for employers, and the marginal product of labor declines only gradually as the workforce increases. To some extent, capital can be substituted for labor if labor costs rise. There is also the possibility of shifting labor-intensive production abroad to take advantage of lower labor costs if the foreign labor is sufficiently productive to make a difference in unit labor costs.

Capital Market

The Supply of Capital. The supply of capital is highly elastic. Physical capital (equipment plus industrial, commercial, and residential structures) can be easily reproduced or expanded (given a bit of time). Furthermore, investors seem willing to construct and employ additional plant, equipment, and buildings whenever the after-tax risk-adjusted rate of return approaches about 3 percent (again, given a bit of time).[6] Put another way, savers will readily finance (buy claims to the earnings of) capital assets at about a 3 percent after-tax risk-adjusted rate of return, substituting additional saving for additional consumption.

Thus, the supply of investment goods and the supply of saving to pay for it are both fairly elastic over time. Conversely, when rates of return on physical capital fall below that level, old assets are not replaced when they wear out. Investors and savers use a bit more of their income for consumption instead, which is, at the margin, virtually as attractive as the foregone investment.

The Demand for Capital. The demand for capital is fairly elastic because the marginal product of capital declines only gradually as the stock increases. Years of real-world observations suggest that it takes a significant rise in the quantity of capital and the capital-to-labor ratio to depress returns and discourage further investment.

Incidence of Taxes on Labor and Capital

Incidence of Labor Taxes. The relatively elastic demand for labor, coupled with the assumption of a highly inelastic supply of labor, means that labor bears most of the initial economic incidence of taxes on labor income. It has become common to assert that all taxes on labor income fall on the worker, including the employers' share of the payroll tax, the employees' share of the payroll tax, the unemployment compensation tax, and the portion of the income tax that falls on wages and salaries.

However, the modern workforce is seen to display some elasticity of supply; and to that extent, it must be assumed that workers will respond to higher tax rates by taking more leisure, and the quantity of labor supplied would fall. A reduced workforce would lower the productivity of the capital stock, suggesting that some of the ultimate burden of a tax on labor would fall on capital owners. (Just as the productivity of a given number of workers is enhanced if they have more capital to work with, the productivity of a given amount of capital is enhanced if there are more workers, particularly more skilled workers, to utilize it. Conversely, if fewer skilled workers were available, the productivity of capital would decline. Think of what would happen to the earnings of the fifth truck at a small trucking company if one of the five truck drivers called in sick.) However, the capital stock may contract in response to a drop in its productivity and rate of return in order to restore its former rate of earnings (see below), which would shift the burden back onto the work force.

Incidence of Taxes on Capital Income. The incidence of a tax on capital income depends greatly on the time frame. Physical capital cannot disappear overnight (in the event of a tax increase), and it takes time to add to the stock of plant, equipment, and buildings (in the event of a tax reduction). Immediately after a tax increase is imposed on businesses or savers, their after-tax returns on old assets would be depressed. Financial market adjustments would come swiftly. Bond and stock prices would fall, restoring after-tax returns for new buyers and forcing new borrowers to offer higher interest rates and rates of return to new investors.

Over time, investors in physical capital can adapt. The high long-run elasticity of supply of capital suggests that a tax imposed on capital will reduce the capital stock until the gross return rises to cover the tax, leaving the after-tax return about where it was before the tax was imposed. Because of the high elasticities of supply and demand for capital, the reduction in the capital stock may have to be substantial to increase its return by enough to cover the tax. As a result, taxes on the earnings of capital assets or on saving may result in sharp reductions in the stock of capital available for production. Downward adjustments in the physical capital stock may take time because capital takes some years to wear out. Eventually, the reduction in the capital stock (or slower than normal growth) will bring it back into balance with the growth in demand for capital associated with population growth.

Adjustment to an adverse shock may take a few years for equipment, a decade or two for structures. (For example, in the 1988–1990 period, Japan instituted an "anti-tax reform" that sharply raised taxes on capital income, including interest and capital gains from stocks, and increased taxes on buildings and land. The result was a particularly severe economic shock that not only affected the returns to physical capital but threw much of the Japanese financial sector into chaos as stock and land prices plunged. It has taken nearly 15 years to sort out the mess. Most shocks are not that severe, and most adjustment periods are not that long.) Positive shocks may be easier to deal with. New equipment can be ordered and placed in service in a few months, new housing constructed within a few quarters, and new commercial or office buildings put up within two or three years.

Implications of Incidence for the Tax Base

The differences in the elasticities of supply and demand for labor and capital suggest that a tax imposed evenly on labor and capital income will reduce the stock of capital by more than the quantity of labor supplied. (Compare Charts 3 and 4.) Such a tax is more distorting of economic behavior than a tax imposed chiefly on labor income.

This suggests an economic advantage from moving away from the so-called broad-based income tax, which actually taxes income used for saving and capital formation *more heavily* than income used for consumption, to various taxes that are saving-consumption–neutral.[7] Such neutral taxes are often labeled as consumption-based or consumed-income–based and are often, somewhat erroneously, described as taxing labor and exempting returns on capital income. These taxes do, in fact, tax quasi-rents and other abnormal returns to capital that exceed the cost of the saving required to obtain the assets.

One argument against major reform of the tax system (moving to a saving-consumption–neutral tax) is that, if labor is truly in highly inelastic supply, sweeping tax rate reductions would do little to boost labor force participation and hours worked and would have only limited economic benefits. Advocates of the tax status quo, or of higher tax rates on upper-income workers, should be careful in making such arguments. A highly inelastic supply of labor would also mean that there is a relatively small reduction in employment from taxes on labor income at all levels, which would make such taxes relatively non-distorting of economic activity.

In theory, for those public finance graduates who put great stock on avoiding "economic distortion" and maximizing "economic efficiency," this should make labor income the ideal tax base. One suspects, however, that people who oppose fundamental tax reform proposals on the grounds that they may appear superficially to be regressive and shift the tax burden from capital income to labor income would not favor heavy taxes on labor income as an alternative.

The Ultimate Burden: Further Tax Shifting in a General Equilibrium Framework

Labor and Capital: Complements More than Substitutes. Output and incomes are at their highest when optimal amounts of labor and capital work together to create the goods and services on which consumers place the greatest value. Depending on the production process, there may be some room to substitute labor for capital (or vice versa) or to substitute skilled labor for unskilled labor.

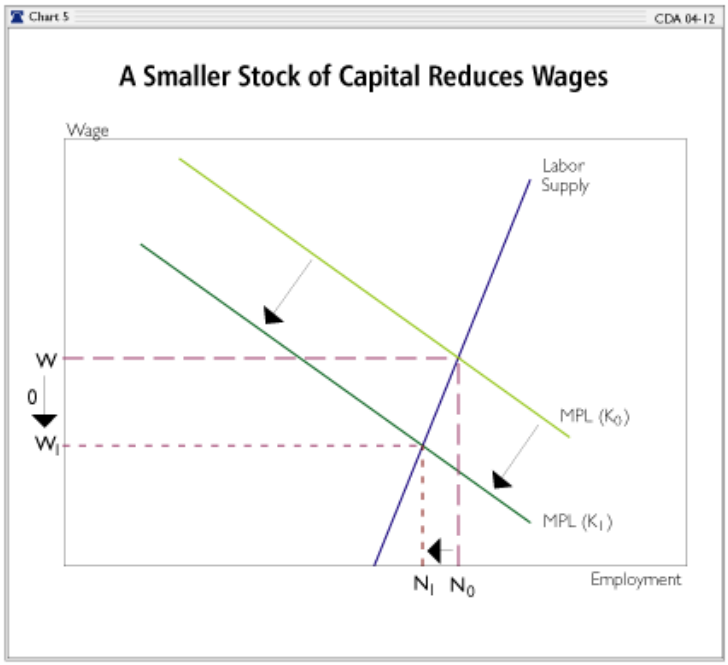
For the economy as a whole, however, and in most situations, the various skills and talents of the workforce, managers, and entrepreneurs and the services of various types of capital are complements in production, not substitutes. That is, the more there is of any one type of factor, the higher will be the productivity and incomes of the other factors that work with it and gain from its presence. If there is more capital for labor to work with, wages rise. If an increase in the skilled work force makes capital more productive, the returns on capital go up.

Taxes Matter "at the Margin." Taxes affect the willingness of labor and capital to participate in production; or, put another way, taxes affect the cost of labor and capital services, and therefore the cost of production. Supply decisions are not usu-

ally all or nothing. One chooses to work a little bit more or less, or to save a little more or less, or to employ a slightly higher or lower number of machines, or slightly more or less powerful or modern ones, on the factory floor. The tax rates that affect such decisions are the marginal tax rates that apply to the last or next dollar to be earned from small reductions or increases in one's economic activity. Taxes that fall at the margin on incremental activity reduce the quantity of resources available for production. With fewer inputs, there will be less output and income, according to the characteristics of the production process.

Lump-sum taxes, such as a head tax, involve a fixed dollar amount owed regardless of income, and so have no impact on decisions about increasing one's earnings. Likewise, one-time retroactive tax hits do not apply to future income, although they may make taxpayers suspicious that they will be repeated. Such taxes are not "at the margin," meaning that they do not affect the last or next dollar earned, and are the only kind of tax that does not reduce incentives and curtail activity. Similarly, rebates of taxes on income of past years, such as President Gerald Ford's 1975 tax rebate on 1974 income tax liability, give no incentive to increase output in the future.

Taxing One Factor Hurts the Other. If a tax falls "at the margin," it depresses the reward to the taxed factor of production, and less of that factor's services will be offered and employed. Because there is less of that input, all the other factors that work with it suffer a loss of productivity and income. They, too, bear some of the burden of the tax. For example, a tax that reduces the quantity of capital lowers the wages of labor. Labor thus bears much of the burden of the tax on capital. (See Chart 5.)



Taxing Capital Hurts Labor a Lot. Insofar as some inputs are more affected by the taxes than others, they may withdraw their services to a greater or lesser extent than others do. As some inputs withdraw heavily from the market, their relative

scarcity affects the productivity, employment, and income of other productive inputs with which they would normally work. Because capital is more sensitive to taxation than labor, a tax on capital will have a relatively large adverse impact on the quantity of capital, which will then cause a relatively large drop in the marginal product and compensation of labor. Taxes on labor hurt capital as well, but because labor is less elastic in supply and withdraws less from the market, the effect is less pronounced.

Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out and a fifth part-time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

Consider another example, involving human capital—specifically, medical training. Suppose the imposition of a progressive income tax were to discourage the supply of physicians by inducing some doctors to retire, by causing others to work fewer weeks per year, and by dissuading people from applying to medical school. One result would be fewer jobs available and lower levels of productivity and incomes for nurses and support staff in medical offices and hospitals. Another would be a rise in the price of health care for consumers (including the government).

For example, assume that four doctors have been operating separate practices in a large town. Each has been taking off o

Such effects may seem small or unlikely at current tax rates, but they are certainly pronounced when tax rates are very high. Historical examples abound. The 1954 tax overhaul in the United States did little to reduce the top World War II tax rates. The top rate went from 92 percent to 91 percent, where it remained until the Kennedy tax rate cuts, which lowered the top marginal rate in stages to 70 percent in 1964 and 1965. President Ronald Reagan often remarked that at such extreme tax rates, it did not pay him to make more that one or two movies a year. There were obvious adverse effects on the U.S. labor markets from the inflation-induced "bracket creep" of the 1970s, which pushed marginal tax rates higher across the board. The top tax rate in Britain before Margaret Thatcher's reforms in 1979 was 98 percent. The infamous British "brain drain" was one result.[1][8]

In short, taxes on capital reduce the wages of labor; taxes on labor reduce the rates of return on capital (at least in the short run, until the capital stock shrinks); taxes on certain types of labor reduce the wages of other types of labor; taxes on certain types of capital reduce the returns on other types of capital. The repercussions of a tax on one factor of production on the income of other factors, or of a tax on one sector of the economy on other sectors, are "general equilibrium" effects. They occur

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outside of the immediate market for the factor or product being taxed and represent impacts that go beyond the initial economic incidence of the tax. Such effects are part of the ultimate economic burden of the tax and represent some of the shifting of the tax burden from the taxed factors or products to other factors and sectors.

Implications of Burden Shifting for the Tax Base

Even for Labor, the Optimal Tax on Capital Is Zero. Several studies in the economic literature illustrate that a zero tax rate on capital income would raise the after-tax income of labor, in present-value terms, even if labor must pick up the tab for the lost tax revenue. That is, a tax on capital is effectively shifted to labor, which pays more than the full value of the tax.

In a 1974 paper,[2][9] Martin Feldstein explored the consequences of a variable capital stock for the distribution of the tax burden. Previous studies that generally assumed no change in the capital stock had concluded that the burden or benefit of a tax increase or decrease on capital was borne by capital. (See the discussion of the corporate income tax, below.) Feldstein showed the importance of allowing for the capital stock to vary.

Feldstein assumed the tax on capital income was eliminated and that on labor was increased in a revenue-neutral manner. He then looked at the least favorable case for labor, in which people were either savers who had no wage income or workers who did no saving. In a "statutory obligation" or burden table or static sense, the savers would enjoy all of the benefit from the initial tax cut on capital income. All workers would face an initial tax increase on wages equal to the dollar amount of the tax cut on capital.

However, Feldstein argued, cutting the tax on the savers would enable them to save more, at the given propensity to save that they display, by leaving them more after-tax income. The added saving would cause the capital stock to rise to a new equilibrium level at which the added saving was just sufficient to cover the added depreciation so as to maintain the incremental stock.

At the higher capital-to-labor ratio, the productivity of labor and the wage would both be higher (Chart 5 in reverse), leaving the workers with higher gross wages and more after-tax income in the steady state despite the higher tax rate on wages. Feldstein showed that, under plausible assumptions, the present value of the increase in future after-tax wages due to the rise in gross wages would be greater than the near-term reduction in after-tax wages due to the rise in the tax rate on wages. Workers would be better off in present-value terms with no taxation of capital.

A 1986 study by Christophe Chamley showed that the optimal tax rate on capital is zero in the long run under a narrow set of assumptions, including a fixed growth rate not affected by taxes, a closed economy, and identical consumers living infinite lives.[3][10] Many other studies on the shifting of taxes on capital to labor have

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expanded on this work by easing a number of Feldstein's and Chamley's restrictions and using different types of models, showing it to be a more general proposition.[4] [11] For example, a 1999 study by Andrew Atkeson, V. V. Chari, and Patrick J. Kehoe demonstrated that Chamley's result holds under greatly relaxed assumptions, including heterogeneous consumers in overlapping generations, an open economy, and a growth rate that is affected by taxes.[5][12]

Speed of Adjustment Is Critical. The results in many of these studies are sensitive to the speed of adjustment of the capital stock. In a 1979 paper,[6][13] Professor Robin Boadway questioned the conclusion that labor would gain in present value by eliminating the tax on capital. He suggested that a low elasticity of saving could slow the rise in the capital stock and delay the expected rise in after-tax incomes. If the added capital formation took long enough, the higher tax rate on labor in the not-so-short short run would then outweigh, in present value, the rise in after-tax incomes in the long run, and workers would be worse off. Similarly, a rise in the tax on capital and a reduction in the tax on labor might make labor better off for many years before the reduction in the capital stock lowered workers' before- and after-tax wages by enough to make them worse off in present value. Boadway suggested that labor might gain from a tax on capital for as long as 65 years before the steady state was reached.

Many of these presentations involve stylized models of a highly simplified economy or population. They achieve the change in national saving and the capital stock solely on the basis of mechanically moving disposable income from those who do not save to those who do, at constant propensities to save (fixed rates of saving out of labor and capital income), and let the change in saving, which is only a fraction of the shifted income in this approach, determine the change in the capital stock. By contrast, in the real world, a tax change affects the cost of capital and the returns to saving, which in turn alter the desired capital stock and level of saving. These changes in saving and the capital stock can be much larger than the dollar amounts of the tax change.

N. Gregory Mankiw has illustrated this mechanical type of model in a paper aptly titled "The Savers–Spenders Theory of Fiscal Policy."[7][14] Such models generally assume a closed economy (not open to trade and international capital flows), limiting the supply of saving available to boost domestic investment. Most assume their elasticities without deriving them from a general equilibrium model tested against actual experience. Hence, they cannot be considered robust pictures of the real world. These studies, of which the Boadway study is a good example, produce unduly pessimistic estimates of the length of time it takes to increase the capital stock following a reduction in the tax rate and of the amount by which the capital stock would rise.

Reality Check. Traditional economists are used to thinking in terms of a fairly constant "propensity to save" and an inelastic supply of saving. They may be

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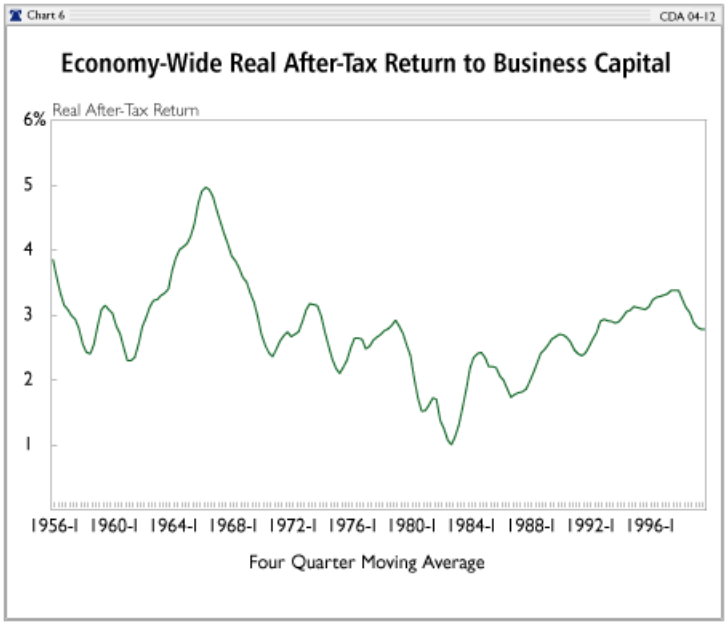
skeptical that the quantity of domestic saving can increase by enough to allow for a strong burst of capital formation needed to bring about a rapid adjustment of the capital stock to a tax shock. Their focus on the channels by which the needed investment is financed is misplaced. They should look first at the speed of adjustment in the historical record of the real world and then worry about how it happens rather than declaring an observed phenomenon to be impossible.[8][15]

How rapidly the economy will invest or disinvest to reach the new equilibrium level of capital depends on several factors, such as the elasticity of saving with respect to the rate of return, the ease with which existing saving flows can be redirected across national borders, the elasticity of the global supply of investment goods and their resulting cost, and the rate at which existing capital wears out (in the case of disinvestment). Although these sources of financing and the production streams of physical capital are flows, they are part of a complex stock adjustment process.

One could try to imagine or to measure separately how flexible these flows may be. Alternatively, one could review the changes in the capital stock that have occurred in the past following shocks to the after-tax rate of return. The latter approach gives an important reality check. If adjustment of the capital stock has proceeded more rapidly in the past than can be accounted for by the flows of saving and investment predicted by some current models, then there may be additional or deeper channels for capital flows in the real world that are not recognized by the models. "It's fine in practice, but it will never work in theory!" is an indictment of the theory, not of the real phenomenon.

Rapid Adjustment of Capital Is the Norm. How fast the capital stock adjusts, which is to say how quickly the return on capital is restored to normal levels after a shock, is really an empirical question, not a theoretical one. Many events, such as technological change, a shift in tax policy, or a shift in inflation, can change the expected returns on capital investment or alter the user cost of capital. The result will be a shift in the desired stock of capital, toward which the economy will move over a number of years.

Are changes in the rate of return to capital merely consequences of business cycles, or are they independent factors that drive savers and investors to adjust the size of the capital stock to conform to new economic conditions, causing changes in the rate of investment that generate business cycles? Gary Robbins of Fiscal Associates and the Heritage Foundation Center for Data Analysis has plotted after-tax rates of return to business capital over time. He finds that the movements in the return to capital, in the desired capital stock, and in the resulting swings in investment activity are seen to lead the business cycle up and down. They are therefore most likely to be a cause, not a result, of the business cycle. (See Chart 6.)



Robbins also finds that the rates of return have tended strongly to remain in the neighborhood of 3 percent. Between 1956 and 2000, the four-quarter moving average rate averaged 2.76 percent and was within half a percentage point of this average 60 percent of the time. Not only do the returns on capital remain within a fairly narrow band over time, but they tend to revert to the band fairly quickly. This implies that, each time there was a major shock to the rate of return, whether traceable to tax, inflation, or technological changes, the quantity of capital has adjusted rapidly and the rate of return was restored soon to its long-run average.[9] [16]

Robbins has tested the speed of adjustment by running regressions looking at implied desired stocks versus the actual deliveries of capital using various distributed lags. He finds that roughly half of the investment in equipment and structures needed to move to the new desired capital stock will occur in the first three years following the shock and that nearly all of the adjustment is completed within five to 10 years (with structures taking a bit longer than equipment). If the bulk of the increase in the capital stock occurs in the first decade following the tax change, as Robbins has found by looking at historical experience, then the case for eliminating the tax on capital is quite strong.

An Open Economy and Flexibility of Saving Speed the Adjustment of Capital. The observed stability in the real after-tax rate of return in the United States and the speed of adjustment of the capital stock to shocks make sense because, in a global economy, the risk-adjusted rate of return in any sub-region should be kept in rough alignment with global returns. Put another way, the size of the capital stock in any one country is sensitive not merely to the innate desired rate of return that humans display (the "marginal rate of time preference"), but also to its relative rate of return compared to that available on capital abroad. The elasticity of the capital stock in a

region is much higher than for the world as a whole.

In a closed economy, net national saving (net of government dissaving) equals private investment, and the speed of adjustment to a new desired equilibrium capital stock following a shock is limited by the change in the national saving rate. In the case of a tax change in the closed economy, the change in national saving and investment will depend on the immediate effect of the tax change on the government deficit (which is the only effect considered in fixed-GDP "static" analysis used by government officials) and on the subsequent dynamic effects of the tax change on the nation's own domestic private saving, investment, and income, which in turn depends on the elasticity of domestic saving and investment with respect to the after-tax rate of return. However, the limitation imposed by the flexibility of own-country saving does not hold in an integrated world economy with international capital flows.

In today's world, it would be a great mistake to assert that the progress of any one nation toward a new equilibrium capital stock following a tax or technological change is limited by its own saving elasticity or by the static tax-induced change in its own national saving rate. Changes in the flow of capital across national borders can have a major impact on the speed of adjustment. For example, following the major tax and monetary policy changes of the early 1980s, new U.S. bank lending abroad dropped from roughly $120 billion in 1982 to under $20 billion in 1984. The drop in U.S. capital outflow of $100 billion more than covered the 1982–1984 change in the government deficit following the 1980 and 1981–1982 recessions and the 1981, 1982, and 1984 tax changes. The shift to domestic lending was large enough to finance a large portion of the increase in private investment in the first half of the decade. In addition, the private saving rate increased. There was only a modest rise in foreign capital flows to the United States in that period. (They rose further later in the decade).

Longer time horizons reinforce the importance of international capital flows and of how a nation treats foreign investment. From the first Spanish and English settlements in Florida (St. Augustine, 1565) and Virginia (Jamestown, 1607) until World War I, a period of over 300 years, the region that became the United States experienced a massive inflow of population and capital from Europe, Africa, and Asia. The capital inflow allowed the country to run current account deficits for most of that period. (There was a brief period of current account surplus for about a dozen years after the Civil War, when the U.S. was deflating and importing gold to restore the dollar to the gold standard at the pre-war parity. Being money, the gold inflow was not considered an import. If gold were treated as a commodity, even these surpluses might have been deficits.) Much of the investment in the early U.S. canals, railroads, and industry was financed by foreigners. International capital flows are not a new phenomenon.

Neither is awareness of the implications of an open economy for the stock of capital, the wages of labor, and the revenues of the state. Adam Smith laid out the case for treating capital with kid gloves in *The Wealth of Nations*:

The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which

he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labor. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour would necessarily be more or less diminished by its removal.[10][17]

In addition to the international flow of capital, one must consider the willingness of savers to increase saving at the expense of consumption and to alter their investment plans as conditions change. Since Michael Boskin's 1978 paper on saving and after-tax returns, people have been a bit more willing to concede some flexibility in saving behavior.[11][18]

Does Atlas Shrug?, edited by Joseph Slemrod, contains a number of interesting studies describing the taxation of the rich and their responses.[12][19] In Chapter 13, "Entrepreneurs, Income Taxes, and Investment," authors Robert Carroll, Douglas Holtz–Eakin, Mark Rider, and Harvey S. Rosen explored the effect of changes in marginal tax rates on the investment behavior of entrepreneurs. They found that "a five-percentage point rise in marginal tax rates would reduce the proportion of entrepreneurs who make new capital investments by 10.4 percent. Further, such a tax increase would lower mean capital outlays by 9.9 percent." They add, "the magnitudes of the estimated response are quite substantial. Our response to the question posed by the title of this volume is that these particular Atlases do indeed shrug."[13][20]

Progressive Taxes on Human Capital May Also Hurt Labor, and a Flat Rate Tax May Be Best. People with particularly high levels of human capital earn returns well above those available to ordinary labor. They may have special talents, such as athletes and entertainers. They may be people with an unusual ability and willingness to make decisions and manage risk, such as successful entrepreneurs. They may be people who have acquired advanced educations and skills. Such people are among the highest paid people in the country. They earn more, but they also face higher average and marginal tax rates than most workers.

Because labor is not homogeneous and there are significant differences in the skill mix across the population, the relative amounts of skilled and unskilled labor can make a difference in the wage rates earned by each group. Taxing the earnings of people with significant human capital at higher rates than ordinary labor may prove to be counterproductive to workers, just as excessive taxation of physical capital appears to be. If people with significant human capital withdraw that capital from the market due to high tax rates, the productivity, wages, employment, and incomes of other people who would have worked with them may be lowered. The tax on the

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personal service income of the highly compensated is then shifted to other workers and factors.[14][21]

Some studies indicate that high-income workers do not seem to reduce work effort in the presence of high tax rates. Several reasons are offered. Upper-income individuals may receive some of their compensation in the form of "psychic perks" rather than financial rewards. The tax may be avoided by changing the method of compensation. The tax may be shifted to other factors.

Psychic perks might include the power and prestige that are associated with prominent positions in business, sports, or entertainment. These perks are unaffected by high tax rates. Economist Henry Simons, godfather of the progressive income tax, offered this as a justification for not fearing adverse consequences from steeply progressive taxation. Simons dismissed the concern that highly skilled workers or entrepreneurs would cut back on their efforts very much simply because they were taxed, on the grounds that their jobs were interesting— "Our captains of industry are mainly engaged not in making a living but in playing a great game."— and that the status and power attached to these jobs were rewards enough to encourage continued effort.[15][22] This cavalier assumption cannot hold, however, when highly progressive rates reach down to tens of millions of small-business owners and professional couples in the middle class.

High tax rates can sometimes be avoided by employing alternative forms of financial compensation that allow the recipients to defer the high tax payments, as with pension plans, or by taking them in a form, such as capital gains or stock options, that is subject to a lower rate of taxation and which also have a deferral feature. There has been a surge in stock options as a form of compensation in recent years, spurred in part by the 1993 Tax Act. That Act raised the top marginal tax rates to 36 percent and 39.6 percent from 31 percent. It also decreed that executive salaries in excess of $1 million would be non-deductible business expenses, apparently in a misguided effort to discourage inequality across the wage scale and to punish corporate boards perceived as being too generous to top management. To the extent that the marginal product of the affected senior management justified the higher salaries, the meddling of the law reduced economic efficiency and equity rather than enhancing it. The options explosion, however, altered incentives for senior management and has been blamed for some recent corporate scandals which, though small in number, have been rather spectacular.

Another reason that the rich may not appear to be stampeding into retirement may be that they are able to shift the tax to other factors. Such people's human capital and talents may be in somewhat inelastic demand. If so, with only a small change in their numbers, they may be able to trigger higher compensation to cover their higher taxes. The burden of the tax would shift to other workers and consumers without the appearance of a large reduction in the hours worked of the rich. In a typical production function, a small distinct factor of production would typically have a smaller elasticity of demand than larger or more readily substitutable factors. As highly paid as some CEOs are, their compensation is generally a small percent of a business's total costs, and their knowledge of the business and ability to run it at

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maximum efficiency may be very hard to replace, at least in the short run. Their administrative or inventive talents, however, may be transferable to other applications, and they may be more mobile, across companies or across borders, than ordinary labor. This would suggest a further ability to shift taxes to other factors.

Neutrality and Economic Efficiency Versus Income Redistribution

Neutral Tax Systems Maximize Income. The potential damage to ordinary labor from excessive taxation of capital, both physical and human, is significant. It suggests that a saving-consumption– neutral tax with a flat rate would serve every type of economic actor better than the current tax system, which includes the graduated comprehensive personal income tax, the corporate income tax, and the estate and gift taxes. The alternatives might include a saving-deferred income tax,[16] [23] a national retail sales tax, a value-added tax (VAT),[17][24] a returns-exempt Flat Tax,[18][25] or some combination.

The more familiar comprehensive or broad-based income tax in use today taxes most income as it is received, including income used for saving, and taxes the returns on saving as soon as they accrue (except for capital gains, which can be deferred until realized). Such taxes fall more heavily on income used for saving than for consumption. The tax bias against saving is made worse by imposing an add-on corporate tax and transfer (estate and gift) taxes.[19][26] Any justification of the comprehensive or broad-based income tax and the additional corporate and death duties must rely on significant non-economic social benefits because these taxes impose high economic costs, including reduced incomes across the board.

Redistribution Lowers Total Income and Can Hurt Those It Is Designed to Help. Early advocates of redistributionist tax systems acknowledged some of the costs. Professor Henry Simons was one of the most influential early advocates of the broad-based income tax. Simons and Professor Robert Haig defended the use of a definition of taxable income that includes both income saved and the subsequent returns on the saving, including capital gains, interest, and dividends (basically, one's income was defined as equal to current consumption plus the increase in one's wealth during the year). This tax base is sometimes described as "the increase in the ability to consume." It results in a tax that is not saving-consumption–neutral; that is, it falls more heavily on income used for saving than consumption.[20][27] Since the rich save more than the poor, taxing saving more heavily than consumption is assumed to be "progressive." Simons also favored making the marginal tax rate structure graduated (higher tax rates imposed on incremental taxable income as it exceeds specified levels) to further increase the progressivity of the system.

The pure Haig–Simons definition of income did not allow for a corporate tax in addition to the individual income tax, however, because that would have been an

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additional layer of double taxation. The professors would have preferred an integrated tax structure that passed corporate income on to shareholders for taxation as it was earned, but were thwarted by practical impediments. Even for these redistributionists, the degree of double taxation and distortion inherent in an add-on corporate income tax went too far.

Professor Simons was well aware that the twin distortions of the tax base and the rate structure inherent in the income tax could lead to a drop in saving, investment, and national income. Therefore, he knew of the possibility of adverse shifts in the tax burden due to heavy taxation of capital income and progressivity. In his magnum opus, *Personal Income Taxation*, Simons wrote:

The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely?.

The degree of progression in a tax system may also affect production and the size of the national income available for distribution. In fact, it is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production?.

[I]f reduction in the degree of inequality is a good, then the optimum degree of progression must involve a distinctly adverse effect upon the size of the national income?.

But what are the sources of loss, these costs of improved distribution? There are possible effects (a) upon the supplies of highly productive, or at least handsomely rewarded, personal services, (b) upon the use of available physical resources, (c) upon the efficiency of enterpriser activity, and (d) upon the accumulation and growth of resources through saving. Of these effects, all but the last may be regarded as negligible?.[21][28]

As mentioned above, Simons dismissed the concern that highly skilled workers or entrepreneurs would make less effort if highly taxed because they found their jobs interesting. Simons took more seriously the possibility that saving and investment would suffer from his policy prescription:

With respect to capital accumulation, however, the consequences are certain to be significantly adverse?. [I]t is hardly questionable that increasing progression is inimical to saving and accumulation?. That the net effect will be increased consumption ?hardly admits of doubt.[22][29]

Simons's remedy was not to do away with progressivity, but to offset its effect on saving by running federal budget surpluses:

The contention here is not that there should be correction of the effects of extreme

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progression upon saving but that government saving, rather than modification of the progression, is the appropriate method for effecting that correction, if such correction is to be made.[23][30]

The assumption that the government virtuously would run large budget surpluses to make up for the anti-growth consequences of a biased and progressive tax system has proven to be utterly naive. Furthermore, a budget surplus cannot make up for the adverse effects that high corporate or individual tax rates and unfriendly capital cost recovery allowances have on the present value of after-tax cash flow from an investment—a calculation that any business school graduate will undertake in deciding on the feasibility of an investment project. Thus, even an offsetting budget surplus would not prevent a reduction in the equilibrium capital stock from a reduction in the marginal return on investment.

Professor Alfred Marshall, who bowed to the general acceptance of progressivity, nonetheless favored a more neutral graduated tax on consumption over a graduated tax on income:

[T]here is a general agreement that a system of taxation should be adjusted, in more or less steep graduation, to people's incomes: or better still to their expenditures. For that part of a man's income, which he saves, contributes again to the Exchequer until it is consumed by expenditure.[24][31]

As Marshall pointed out, one does not need to adopt a non-neutral income tax to achieve progressivity. Saving-consumption–neutral taxes can be made progressive as well. In fact, it is not necessary to have graduated tax rates to achieve progressivity. A tax which exempts some amount of income at the bottom and imposes a flat marginal tax rate on income above that amount is progressive because the average tax rate will rise with income. A graduated consumption-based tax is not as economically efficient as a flat rate consumption-based tax because it increases the tax penalty at the margin the more productive an individual becomes and the more effort he or she makes. Nonetheless, it is far more efficient than a graduated income tax.

The tax bias against saving that was built into the income tax may have been seen as a way of putting a kinder face on capitalism and defending the free market and private property against the foreign ideologies of fascism, national socialism, and communism that seemed to be sweeping the world in the 1930s. In retrospect, however, we can see that the broad-based income tax retards investment, which reduces wages and employment and keeps people who lack savings and access to capital from getting ahead. Taxes on capital formation hurt the poor more than the rich (who can simply exchange the pleasures of current consumption for the future income of similar present value that their saving would have generated).

Implication of Dynamic Effects of Taxes for Estimating Federal Revenues

A better understanding of the economic consequences of taxation would also benefit

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the Treasury and the Congress as they plan the federal budget and contemplate changes in the tax system. Government revenue estimators generally ignore the effect of tax changes on the overall level of economic activity, employment, incomes, payroll, profits, dividends, and capital gains. This method is known as "static revenue estimation" or "static scoring."

Static scoring leads to misestimates of the effect of tax changes on revenues. In particular, the revenue losses from tax reductions that would promote an increase in economic activity are overstated, and the revenue gains from raising taxes in a manner that would retard the economy are overstated. Different tax changes have different effects on the economy. Ignoring these effects denies Congress and the Executive important information in choosing among tax proposals. Inaccurate revenue estimates therefore interfere with budget planning and assessment of proposed tax changes. In particular, they exaggerate the difficulty in achieving fundamental reform of the tax system.

By contrast, "dynamic scoring" would take into account the effect of tax changes on total income and its component parts. Dynamic scoring would lead to more accurate revenue forecasting and, one would hope, to tax bills that are more concerned with increasing national and individual income and less inclined toward redistributing a fixed pie.

V. Burden Tables: An Exercise in Misdirection

Whenever a change is proposed in the tax system, one of the first questions asked is, "What is the distribution of the tax increase or decrease?" That is to say, "If this tax change is enacted, who will pay more, and who will pay less?" or "Who will be helped or hurt by the tax change?" One possible concern is how the "burden" is distributed among people of different incomes; that is, how the tax change affects the progressivity of the tax system.

Burden Table Assumptions, Methods at Odds with Economic Theory, Reality

Tax analysts in the research community, the JCT, the Congressional Budget Office (CBO), and the Office of Tax Analysis of the Treasury (OTA) present "burden tables" or textual analysis to answer these questions. The presentation of these estimates has considerable political import. Therefore, it is important to remember that, when tax analysts prepare burden tables or present a description of tax incidence, they must make assumptions and apply conventions to assign the incidence of the tax to various economic actors, be they consumers, workers, savers, etc. Among other things, they must make assumptions about the responsiveness of labor, capital, and consumers to the tax and what time frame to consider in presenting the burden. Some of these conventions have more to do with convenience than with accuracy and are, in fact, highly arbitrary and often contrary to economic reality.

Incidence, Not Burden. These "burden tables" or "distribution tables" show how a tax proposal would alter tax payments of individuals across various income classes or quintiles in a given year, other things held constant. (One such table is the Urban–Brookings Tax Policy Center Microsimulation Model (version 0304-2), prepared jointly by the Urban Institute and the Brookings Institution and available on-line. Other

methods of display are possible, such as listing how many tax filers get tax reductions of various amounts, how the tax cut is distributed among single filers, joint filers, families with children, the elderly, etc.)

Such tables are based on existing levels of each type of pretax income and the existing distribution of whatever exemptions and deductions are in force at the time of the tax change. They attribute each tax either to consumers or producers, or to labor or capital, with a vague nod to economic theory in what would be a limited partial equilibrium analysis of the shifting of the tax within its own market if it were done consistently. However, they generally assume that taxpayers' aggregate incomes and behavior are not affected by the tax change.

Thus, the analysis is cut short of a full exploration of the economic consequences of the tax, and the ultimate burden of the tax is not described. Consequently, these "burden" tables attempt to demonstrate only the initial incidence of the taxes (and should be renamed "incidence tables"). They tell us virtually nothing about the distribution of the burden of the taxes after people adjust their behavior as a result of the levies.

Inconsistent Attribution and Sloppy Theory. Furthermore, the conventions used in tax analysis are often inconsistent from one tax to the next and fail to do a good job of demonstrating even the initial incidence of the taxes. In standard JCT burden tables, and in Treasury and CBO analytical work, *consumption taxes* are usually assumed to be "passed forward" to consumers in the form of higher prices. These taxes include:

Retail sales taxes and value added taxes, and

Excise taxes (whether imposed on the manufacturer, the distributor, or at the point of retail sale).

Meanwhile, *income taxes* and other *taxes on factors* are assumed to be "passed backwards" to workers and owners of capital in the form of lower take-home pay and after-tax incomes from saving and investing. These taxes include:

- The personal income taxes (federal, state, and local);
- The corporate income taxes (federal, state, and local);
- The payroll tax;
- The estate and gift taxes (federal and state); and
- Property taxes.

Customs fees are an exception to this pattern. They are consumption taxes but are assumed (by the Treasury) to be borne by the suppliers of the foreign labor and capital that produced them.

Consumption taxes, such as a retail sales tax, a VAT, or excise taxes, whether imposed on consumers or on manufacturers, are routinely described as being paid by consumers in the form of higher prices because it is assumed that consumers are less flexible than producers, so that consumer prices increase by an amount equal to

the tax, with none of the tax borne by the producers of the taxed goods. It is as if the supply of goods and services were totally elastic, such that production would dwindle to zero if there were any reduction in the price received by the producers, so the consumers must foot the entire bill.

The personal income tax, however, which falls on labor and capital income of individuals, is routinely described as falling entirely on individual income earners in the form of lower after-tax incomes, with none borne by the consumers of their output. The payroll taxes on wages are similarly assumed to be borne entirely by labor. The estate tax is assumed to fall on the decedents, and the gift tax, if triggered before death, on the donors. The distribution of the corporate income tax is so uncertain that it is left out of most burden tables but is thought to be borne mainly by either shareholders (at least in the short run) or workers (in the long run, as capital adapts). These taxes are described as if workers, savers, and investors offered their labor and capital in totally inelastic supply, undiminished in quantity, when the tax cuts their compensation. It is assumed that they make no demand for an increase in compensation in response to the tax, so they swallow the entire burden of the income and other factor taxes that they pay.

These questionable presentations of initial incidence unfortunately can have a profound effect on the prospects for adoption of one or another tax change. Understanding the shortcomings of the existing "burden" tables that are really bad efforts at "incidence" tables would improve the policy debate. The goal is not so much to arrive at a better presentation of "incidence" but to redirect attention from the concept of initial incidence and to refocus the debate on the actual economic consequences of tax changes, the ultimate burden of taxation, and the ultimate economic benefits of favorable tax reform.

Snapshots in Time Rather Than Lifetime Impacts. It is very misleading to display the distribution of tax changes as affecting people only in proportion to their current earnings.

A very large share of the income inequality in our economy is due to the fact that more experienced and older workers earn more than their younger counterparts. Most people will experience a gradual increase in their real incomes as they advance in their careers and their work experience builds, followed by a decline in current earnings upon retirement. Even if everyone had the same lifetime incomes, people currently age 50 would probably display higher incomes than people currently age 20 or currently age 80. It is misleading to characterize these normal age-related or experience-related changes in income over peoples' lives as class-based income inequality. That, however, is exactly what the burden tables do when they lump all ages together.

Similarly, saving behavior and ownership of assets vary with age. A reduction in the tax rate on capital gains does nothing this year for someone who has no capital gains this year but will help him in the future when he has gains to realize. Suppose Mr. Jones turns 70 this year and decides to sell his business of 50 years for a $1 million gain. Mr. Smith is only 69 and will wait to sell his business until next year. The

reduction in the capital gains tax from 20 percent to 15 percent saves Mr. Jones $50,000 this year and saves Mr. Smith nothing. Should Mr. Smith feel left out? Hardly. He'll get his benefit next year. The burden tables would suggest massive unfairness each year because one (different) person each year gets a $50,000 tax break (in the one year of his life in which he has a million dollar gain) and another person the same year gets none.

In this illustration, the capital gains of both Jones and Smith had built up over many years. Should the gain be counted as occurring only in the year it is taken, boosting the realizer into the top quintile? Would it not better be counted for distribution purposes as it is accrued (at an average gain of $20,000 a year), which would make it clear that each man is solidly middle-class? Should it be counted at all, in that the gain is merely the accumulated reinvestment (saving) of income recorded in the gross domestic product (GDP) in the years it was originally earned? That makes it double counting, which is why economists do not count capital gains in national income (and why the capital gains tax is double taxation to begin with).[32]

The Treasury has recently constructed and "aged" a panel of taxpayers whose returns it has followed for several years, based on a sample of the taxpaying population.[33] The panel enables the Treasury to examine how a tax change would affect a typical taxpaying population over time, not just in a single year. As an illustration, the authors compared the expanded distributional analysis of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) over the span of the then-current budget period (2004–2013) to the distribution calculated at a point in time. Looked at over time, the major provisions of the bill benefitted many more taxpayers than was indicated by a one-year snapshot.

In the panel study, some taxpayers who lacked dividends income or capital gains in some years of the period had dividends or capital gains in other years and benefitted from the bills' reductions in the tax rates on dividends and capital gains. Some taxpayers who were in the lowest tax brackets in some years were in higher brackets in others and benefitted from the reduction in marginal tax rates in the four highest brackets at some time during the period. The authors report that:

For example, in the first year 34.7 percent of taxpayers would benefit from the reduction of tax rates above 15 percent, whereas over ten years 60.7 percent would benefit in at least one year…. In the first year, some tax return filers do not benefit from any of the major provisions of EGTRRA because they have no income tax liability under pre-EGTRRA law and do not qualify for the expanded refundability of the child credit. But over time, nearly all taxpayers, 94.4 percent, would benefit.[34]

Over time, then, the benefits of the bill are far more widely distributed than is indicated by the ordinary one-year snapshot of the distribution of the tax reduction.

This research goes far in revealing the flaws inherent in standard distribution tables and the distributional objections to growth-oriented tax changes. Nonetheless, it still leaves out entirely the economic adjustments induced by the tax changes, which may have an even greater role in spreading the benefits of a growth-oriented tax change. For example, the reduction in the tax rates on dividends and capital gains

lowers the service price of capital and will induce more investment, which will lead to higher productivity and higher wages across the board. Consequently, anyone who works will benefit from the higher wages triggered by the bill, even if he or she never has dividends or capital gains. Even people living entirely on Social Security will benefit from the lower cost structure and more plentiful supply of goods and services made possible by the lower tax rates on wages and capital income. These additional benefits can only be found by taking into account the shifting of the tax burden and the changes in people's economic circumstances that are due to the economic adjustments to the tax changes.

Measuring Dynamic Responses Essential to a True Burden Table

The burden tables normally produced by the Treasury, the congressional committees, and outside researchers do not take into account the economic consequences of taxation and the resulting shifts in incomes and tax burdens. These shifts can have very large effects on the pre-tax incomes of workers, savers, and investors at all income levels, which means that they can have a major effect on the level and distribution of tax burdens. Because the burden tables ignore these effects, they do not accurately measure the tax burden, either in the aggregate or as to how it is distributed among different groups within the population.

A true burden table can only be created by undertaking an assessment of the dynamic effects of the tax on economic behavior. The information needed to produce a true burden table is identical to that which is required for dynamic revenue estimation (discussed earlier). Government revenue estimators are very reluctant to attempt dynamic scoring of the revenue effects of tax changes, claiming that the process is too difficult and controversial. If that is correct, then they need to give up the pretext that the burden tables that they routinely produce are accurate. If one cannot do dynamic scoring of tax changes for budget purposes, one cannot generate accurate burden tables. If burden tables are feasible, then so is dynamic scoring, and it should be adopted forthwith.

VI. Analysis of Some Specific Types of Taxes

The Corporate Income Tax

Initial Incidence of the Corporate Income Tax. No competent student of taxation believes that corporations pay the corporate income tax. Only people pay taxes. Things and abstractions do not pay taxes. A corporation is, in law, a legal person, but that is, in fact, a legal fiction. Therefore, corporations do not really pay the corporate income tax. Conservative Nobel Prize–winning economist Milton Friedman is well known for espousing that view, but liberal economists share it as well. The liberal Nobel economist Wassily Leontief told *The New York Times* 20 years ago:

Corporate income taxes fall ultimately on people. Economists have tried but have never succeeded in finding out how the weight of these taxes is ultimately distributed among income groups. There can be little doubt that elimination of corporate income taxes would simplify our tax system and limit its abuse.[35]

Ultimate Burden of the Corporate Income Tax. Tax analysts generally assume

that the corporate income tax is borne, at least in the first instance, by shareholders. As the Treasury put it, "because corporations are owned by shareholders, corporations have no taxpaying ability independent of their shareholders. Corporations pay taxes out of the incomes of their shareholders."[36] However, the analysis does not stop there.

Economists also recognize that corporate taxes, though initially coming out of shareholders' incomes, have further economic repercussions that shift part of the ultimate burden to others. As the Treasury report continues:

Importantly, the burden of the corporate income tax may not fall on shareholders. A corporate tax change could induce responses that would alter other forms of income as well. For example, some of the burden may be shifted to workers through lower wages, to consumers through higher prices, to owners of non-corporate capital through lower rates of return on their investments, or to landowners through lower rents. This shifting might not happen quickly, so the short-run incidence could well differ from the long-run incidence.[37]

(Note the Treasury's interchangeable use of the terms incidence and burden, for both the short-run own-market effect and the long-run general equilibrium outcome.)

In years past, the Congressional Budget Office has also suggested that the corporate tax falls about half on owners of capital and about half on the workforce, arguing that the tax depresses capital formation and therefore depresses productivity and wages, shifting at least some of the burden to labor.

More recently, the Treasury and the CBO have assumed that the corporate tax is borne by owners of all capital (corporate capital and competing non-corporate capital), and none by workers. Most economists believe that the burden of the corporate tax is borne to some extent by shareholders, workers, and consumers (who are often the same people in different roles), but they do not agree on the division of the burden. Because of the uncertainty in the profession, the JCT has stopped assigning it to anyone in the official "burden tables." If the corporate income tax were raised and individual income taxes were cut by equal amounts, the burden tables would show a reduction in the tax on the population with no loss of federal revenue—an ultimate (and quite impossible) free lunch!

Of course, someone pays the corporate income tax even if the JCT cannot point out who it is. In fact, a modern view of the corporate tax in the context of an open, globally integrated economy holds that the burden of the corporate tax falls primarily on labor after all adjustments are taken into account.

Varying Views of the Corporate Tax. In 1962, Professor Arnold Harberger produced a seminal article on the incidence of the corporate income tax.[38] The article did more than analyze the corporate tax; it showed the importance of going beyond narrow partial equilibrium analysis in looking at the effects of taxation.

The early Harberger work suggested that the corporate tax was borne by the owners of all capital, not just corporate capital. Harberger assumed a *closed economy* with a *fixed total capital stock*. The capital could be allocated either to the corporate or to

the non-corporate sectors, which were assumed to produce somewhat different goods and services.[39] If a corporate tax were imposed, raising the tax rate above that of the non-corporate sector, capital would migrate to the non-corporate sector. Gross returns would rise in the corporate sector and fall in the non-corporate sector to equalize after-tax yields between the sectors. Thus, a portion of the corporate tax would be shifted to non-corporate capital. There would also be an efficiency (dead weight) loss that would make the burden greater than the amount of the tax itself.

In later work, Professor Harberger changed his assumption that the economy is closed and concluded that the corporate tax is borne largely by domestic labor, at least in the case of a small open economy that has little impact on the world rate of return.

Putting a tax on the income from corporate capital would simply lead to adjustments whereby less capital would be at work in that country…. Where would the capital go? It would go abroad…. In realizing that the presence of the tax implies that significantly less capital will be combining with the same amount of total labor (in the small developing country), it should come as no surprise that the equilibrium wage has to be lower. But there is an additional and more critical reason (above and beyond simple capital labor-substitution) why labor's wage must fall: the need to compete with the ROW [rest of the world] in the production of manufactures (corporate tradables). The tax is a wedge that has been inserted into the pre-existing cost structure. The prices of corporate tradable products cannot go up because they are set in the world marketplace; the net-of-tax return to capital cannot go down (except transitorily), because capital will not be content to earn less here (in the small developing country) than abroad. Some element of cost has to be squeezed in order to fit the new tax wedge into a cost structure with a rigid product price at one end and a rigid net-of-tax rate of return to capital on the other. The only soft point in this cost structure is wages. If they do not yield, the country may simply stop producing corporate tradables. Or, if the country continues to produce such goods, then wages must have yielded—by just enough to absorb the extra taxes that have to be paid….[40]

Harberger goes on to point out that the United States is a large country, not a small one, so the exit of U.S. capital would somewhat depress the rate of return to capital in the world, which would somewhat mitigate the capital flight and reduce the share of the tax burden passed on to U.S. labor. Nonetheless, he estimates that U.S. labor would still have to bear seven-eighths of the corporate tax.[41] *Harberger assumes an unchanged world capital stock, i.e., that the world stock of capital does not fall to restore after-tax returns to the levels they enjoyed before the imposition of the U.S. tax. If one instead adds the assumption that the world capital stock is elastic over time with respect to the rate of return, then even this modest offset to the impact of the U.S. corporate tax on U.S. labor would vanish.*

Harberger reiterated his analysis in a recent interview in the *IMF Survey* conducted by Prakesh Loungani.[42]

Loungani: The effects of some economic policies are better understood thanks to your academic contributions. You did path-breaking work on whether capital or labor

bears the burden of the corporate income tax.

Harberger: There are interesting developments to report on that front. In the closed-economy case that I analyzed in the 1960s, the natural result is that capital bears the burden of the tax and can easily bear more than the full burden. But my students and I have now analyzed the open-economy case, which is more applicable to today's global economy. The result in this case is that labor bears the burden and can easily bear more than the full burden.

Loungani: That's quite a flip. Why does it happen?

Harberger: Think of the so-called "tradable goods" sector of an open economy, the sector that produces goods that are traded on a world market. The prices of these goods are determined in the world market. And, with an open economy, the rate of return to capital is largely determined in the world market, because capital can flow from country to country in search of the highest return. Now the government gets in there and tries to impose a corporation income tax on capital. Well, who bears the burden? Capital can move across national boundaries to try to escape the tax. So it's labor, the factor of production that can't easily escape national boundaries, that ends up bearing the burden of the tax.

In this analysis, part of the fixed quantity of U.S. capital relocates abroad, and domestic labor suffers a loss in income and therefore bears the entire corporate tax, plus a dead weight loss. One could go two steps further in refining the analysis, however.

First, one could note the effect of the shift of U.S. capital abroad on foreign labor and world capital returns while retaining the idea of a fixed total world capital stock. This would put some of the burden of the corporate tax back on U.S. capital. If the United States were a very small economy, the shift in U.S. assets abroad would have little impact on global rates of return, and the Harberger result for the U.S. would follow. Given the size of the U.S. economy, however, there would be some effects abroad. The tax on domestic U.S. corporations would drive some investment offshore, but that investment would have to compete harder for available foreign labor. Initially, the foreign capital–labor ratio would rise, increasing returns to foreign labor but reducing returns to foreign capital, consisting of the expatriate U.S. capital and the pre-existing foreign capital. The misallocation of the fixed world capital would depress capital returns here and abroad. At least temporarily, all capital, U.S. and foreign, would suffer some loss of income due to the U.S. tax. Nonetheless, U.S. labor would bear most of the burden of the tax, which would exceed the tax revenue due to the added dead weight burden of the economic distortions.

Second, however, one really must relax the (still partial equilibrium) assumption of a fixed quantity of domestic and world capital. Capital formation has been shown to be sensitive to the after-tax return. Over time, there would be a reduction in the quantity of foreign-located capital (whether foreign- or U.S.-owned) to restore its normal after-tax return, reducing the gains to foreign workers. Foreign returns to capital would not decline significantly. The reduction in the quantity of U.S. capital would restore its original after-tax return as well. Capital would bear very little of the burden of the U.S. corporate income tax. In the long run, one should expect a

general equilibrium result that the main losers would be U.S. workers.

Other analysts have a different view of the corporate income tax in an open, or partially open, economy. For example, Jane Gravelle and Kent Smetters construct a model in which the largest part of the corporate tax can be borne by domestic capital in spite of trade and capital flows, in effect restoring the old view of who bears the corporate tax.[43] They get this result by assuming imperfect substitution of domestic and foreign capital (people prefer the stocks and bonds of their home country governments and businesses) and imperfect substitution of domestic and foreign goods and services. They also assume a fixed total capital stock to abstract from the issue of the elasticity of saving.

In their four-sector model, they get the usual result of a corporate tax shifted mainly to domestic labor when substitution elasticities are very large: Capital moves abroad, equalizing the domestic and foreign after-tax rates of return. The capital flight depresses rates of return to foreign capital ("exporting" some of the tax) and raises foreign wages. Wages of domestic labor (the immobile factor) fall. But assuming lower elasticities, which the authors feel are more plausible, less capital shifts abroad (because it is assumed to be somewhat immobile too). People are willing to accept a drop in the after-tax return on capital to own domestic assets, and the tax can open a permanent differential between rates of return at home and abroad. As a result, the bulk of the corporate tax falls on domestic capital, less on domestic labor. Some capital is exported, which shifts some of the tax to foreign capital with some gains to foreign labor, but less than in the high-elasticity case.

There are several areas of concern with the Gravelle–Smetters approach:

- The assumption of a constant world capital stock is unrealistic, just as it is in the Harberger analysis, and simply throws out the bulk of the adjustment process. The quantity of capital has been seen to vary substantially to restore its after-tax rate of return to normal levels over time following a tax change. The lower worldwide return on capital post-tax would depress global capital accumulation and shift the tax back to labor.
- The assumption of a low substitutability of domestic and foreign capital appears to be at odds with observed international flows of financial and physical investment. Even if savers and investors on average display a home country preference, the capital markets act very "open" if even a few large savers are, at the margin, willing to move capital freely across borders. It may be that many people never buy foreign securities and many companies prefer to invest at home, reducing the average ratio of global to local assets in domestic portfolios. At the margin, however, there are many people, businesses, and institutions that freely arbitrage across borders. Multinational financial and non-financial corporations send funds and direct fixed investment all over the world. Consider that the outflow of U.S. capital has been averaging roughly $400 billion a year and foreign investment in the U.S. has been averaging over $500 billion a year for some years. The sum of the annual cross-border investment flows has been about $1 trillion—almost as large as total annual investment in the United States.
- In the cases where the corporate tax falls on domestic capital, the Gravelle–Smetters model implies that a tax increase can lower the after-tax rates of

return on capital for a very long time and can lead to prolonged differences in the after-tax rates of return on domestic and foreign capital. This is disturbing on two grounds. First, in the modern world, returns on global assets of similar risk and quality do not display wide and permanent differentials. Second, taxation of capital has risen drastically over the past hundred years with the inventions of the corporate and personal national and sub-national income taxes, property taxes, and estate and inheritance taxes, yet there has been no correspondingly large change in the real, risk-adjusted after-tax yields on capital, either financial or physical. It appears that capital, by adjusting its quantity, is able to shift a large part of the taxes aimed at it onto other factors.

The Payroll Tax

The entire Social Security payroll tax on wages is remitted by employers to the Treasury, but according to statute, it supposedly is paid half by employees and half by employers ("statutory obligation"). Most economists would argue that, legislative language notwithstanding, the initial incidence and the ultimate economic burden of the entire tax is borne by workers. Why? The whole tax comes out of gross labor compensation that could otherwise have gone to labor. Furthermore, the supply of labor has been thought by many to be highly "inelastic." Consequently, the tax is assumed to be "shifted" almost entirely onto the worker, not only in its initial incidence, but also in its ultimate burden.

A more modern view of the labor force suggests that the workforce, particularly certain subgroups, such as secondary workers in a family and teenagers, does respond to changes in the after-tax wage. A general equilibrium economist would argue that this partial elasticity of the supply of labor would further shift a portion of the ultimate burden of the payroll tax to other economic factors, such as consumers, other types of labor, and any immobile forms of capital such as land, as the labor supply shrinks in response to the tax. Mobile capital, however, would bear little of the burden, as it could move abroad or shrink in quantity to restore its original rate of return.

The Unified Estate and Gift Taxes

The federal unified gift and estate tax (the "death tax") is an additional layer of tax on saving. Every cent saved to create an estate has either been taxed or will be taxed under some provision of the income tax. Ordinary saving by the decedent was taxed repeatedly when the decedent and the companies she or he may have owned shares in paid individual and corporate income taxes. Saving by the decedent in a tax-deferred retirement plan will be subject to the heirs' income taxes and was subject to the corporate income tax in the case of stock holdings. The death tax is always an extra layer of tax.

Prior to 2001, the estate and gift tax rate topped out at 55 percent if a parent left money to a child but could reach almost 80 percent under the generation-skipping tax (GST) if the bequest went to a grandchild or other relative more than one generation removed from the decedent. (The GST rate is equivalent to imposing a 55 percent tax on the estate as if it had gone to a child and then imposing another 55 percent rate on the remaining 45 percent of the estate as if it had gone from the

child to the grandchild. Congress didn't want to miss out on any potential revenue by letting anyone's death go untaxed!)

If a near-to-retirement couple were thinking of working an extra year just to add to an estate, the combined income, payroll, and estate tax rates could have exceeded 78 percent, or even 90 percent with the GST. That produced quite an incentive to retire instead of continuing to work or to reinvest interest or dividends in an estate. The 2001 Tax Act reduces the top estate tax rate to 45 percent by 2007 and raises the exempt amounts for the estate and gift tax. It will eliminate the estate tax (but not the gift tax) in 2010, but the tax will reappear at the old rates in 2011 unless Congress votes to make the repeal permanent.

Under the conventions used by the Treasury, the unified estate and gift tax is assumed to be borne by the decedents (or donors if they exceed exempt amounts before they die). The assumption about decedents is distinctly odd, as they are beyond feeling any pain. The heirs are the ones who get lower bequests due to the tax, and they are a more reasonable choice for victims. However, there are no readily obtainable data on who the heirs are, so the decedents are selected by default. This is much the same rationale as that offered by the drunk who looks for his lost car keys on the sidewalk under the lamp post, instead of in the parking lot where he dropped them, because under the lamp post is the only place with enough light to search by.

An even odder form of misrepresentation is that this tax is not even called a tax in the National Income and Product Accounts, which instead label it as an innocuous-seeming and voluntary-sounding "asset transfer" from the private sector to the government. It is not a tax, in NIPAnese, because it falls on the principal rather than the income of the assets—a distinction without economic meaning or merit.

There is one way in which the decedents could be said to have borne the estate tax. If they had a rigid goal of how much after-tax bequest they wished to leave their heirs and trimmed their consumption during their lifetimes to save additional sums or to buy additional life insurance to cover the added tax cost of leaving an estate, then one could say that they had borne part of the burden of the tax. However, it is a fundamental law of economics that the more expensive you make something, the less people will do of it. The estate and gift taxes seem far more likely to reduce the personal saving and capital accumulation of the potential donors, rather than their personal consumption, and therefore to reduce the inheritances of their heirs.

The heirs do not bear the full cost of the estate and gift taxes, however. These taxes add to the tax on capital formation and result in a reduced stock of capital. The economic consequences of the reduced capital stock are largely borne by the labor force.

In spite of (or because of) its horrendously high tax rates, the death tax probably doesn't raise any net revenue for the government. Professor B. Douglas Bernheim of Stanford estimates that avoidance of the estate tax by giving assets to children, most of whom are in lower income tax brackets than their parents, costs more in income tax revenue on the earnings of the assets than the estate tax picks up.[44] Gary and Aldona Robbins of Fiscal Associates estimate that the reduced saving and

capital formation lower GDP and wages by so much that the resulting reductions in income and payroll tax collections exceed the estate tax take.[45] If Bernheim and the Robbinses are each even half right, the tax loses money. Estate tax repeal would pay for itself and would encourage wealth and job creation.

VII. Conclusion

Centuries of thought and research have been devoted to the relationship between taxes and economic behavior. Classical pioneers explored the price or incentive effects of taxes on the supply of factors and products over 200 years ago. Micro-economists refined the concepts a century later. In the middle of the past century, the Keynesian focus on aggregate demand turned taxes into a demand management tool divorced from price or incentive effects—a theoretical detour that the monetarist school and the neoclassical resurgence have largely corrected.

Today, although more sophisticated work than ever before is being done in the tax field, it appears that the original insights of the classical pioneers still hold true. Strenuous efforts to find exceptions to the "law of demand" have largely come a cropper. It is still the best presumption that, if something is made more expensive, people will buy less of it, and if something is made less expensive, people will buy more of it. This law still applies to work, saving, and investment and to the trade-off between current and future consumption, and between consumption of market goods and leisure. Increase the tax on effort, and less will be supplied. Reduce the tax on effort, and more will be offered. Fewer inputs mean less total output. Factors of production are largely complementary to one another. More of one factor of production boosts the productivity and income of the other factors. Less of a factor limits the productivity and income of all the other factors.

It is well understood in the economics profession that the current tax system imposes heavier taxes on income used for saving and investment, and on the formation of human capital, than on income used for consumption. Today, most economists would agree that these tax disincentives to save and invest, to work and take risk, have consequences. They lead people to undersave and overconsume and to work less and play more. These modern advances in economic understanding strongly urge us to dispose of the current income tax structure and replace it with a flat rate tax that is neutral in its treatment of saving and consumption.

The tax biases against saving and investment and steeply graduated tax rates were introduced for the purpose of improving "social equity." In decades past, it was assumed that the added layers of tax on income used for capital formation would do relatively little economic damage, would inconvenience only the wealthy, and would provide significant income redistribution. It is becoming apparent, however, that most of the taxes that seem to fall on those who supply physical capital, intellectual capital, or special talents to the production process may actually be shifted to ordi-nary workers and lower-income retirees in the form of reduced pre-tax and after-tax incomes.

The adverse economic consequences of non-neutral taxation and graduated tax rates, and the resulting adverse impact on "social equity," are not displayed in the so-called burden tables used to inform the public policy debate or the votes in

Congress. With bad information, the public and the Congress are left with a bad tax system and a sub-optimal economy.

A more rational system of calculating and displaying the real tax burden—one that took full account of how taxes are shifted—would make it easier to explain and adopt a more rational tax system. A more rational tax system, in turn, would maximize the efficiency of the economy as a whole and would enable every individual to maximize his or her potential lifetime productivity and income.

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[1]U.S. Department of the Treasury, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, January 1992, p. 146.

[2]Statutory obligation is not the same thing as the obligation to remit, which involves the tax collection laws and process. A tax is in a sense "paid" by whoever is legally responsible for remitting the money to the taxing authority, whether that is the U.S. Treasury or one of the various state and local tax departments or offices. Most people are sophisticated enough to realize that who sends in the check does not indicate who pays the tax. Income tax withholding is a good example. A worker's employer by law must transmit income taxes withheld from a worker's paycheck to the Treasury each pay period, but the tax actually falls according to statute on the worker's wages, not on the employer's income. "Remittance" is not the same thing as "statutory obligation."

[3]See Don Fullerton and Gilbert E. Metcalf, *The Distribution of Tax Burdens*, International Library of Critical Writing in Economics, No. 155 (Northampton, Mass.: Edward Elgar Publishing, Inc., March 1, 2003). Fullerton and Metcalf use the term "statutory incidence" to refer to the statutory obligation as defined by the tax law (what is here called "statutory obligation"). They use the term "economic incidence" to refer to the changes in people's economic welfare brought about by the tax, in that the tax changes equilibrium prices, with wide-ranging consequences, what is here called "ultimate economic burden." For example, a tax on a particular product induces consumers to alter their purchases, which in turn affects the prices or returns paid to each input, thereby affecting the welfare of consumers, workers, and suppliers of capital. Two terms are not really enough, however. There is still the need to distinguish between the economic incidence revealed by "partial analysis," which involves the changes in the price of the taxed product and its effect on that product's consumers and producers (and which must further be broken down into the short- and longer-run effects), and "general equilibrium analysis," which must include all the subsequent adjustments as consumers switch to other products and factors shift to other uses, including leisure, or are reallocated between consumption and capital accumulation, altering the capital stock over time and affecting wages throughout the economy. The Fullerton–Metcalf anthology contains many seminal papers on tax incidence that explore these different facets of the analytical spectrum.

[4]Alfred Marshall, *Principles of Economics*, 8th edition (1920) (Philadelphia, Pa.: Porcupine Press, reprinted 1982), Chapter IX, pp. 343–345. The first edition was printed in 1890. Tax incidence and tax shifting are not new notions.

[5]Victor R. Fuchs, Alan B. Krueger, and James M. Poterba, "Economists' Views About Parameters, Values, and Policies: Survey Results in Labor and Public Economics," *Journal of Economic Literature*, Vol. 36 (September 1998). Some writers believe that the empirical evidence points to a labor supply elasticity of zero or less, which could lead to more work effort at higher tax rates and "reverse" tax shifting. For a number of reasons, that outcome is highly unlikely. For a more sympathetic view, see Jane Gravelle, "Labor Supply Elasticity and Dynamic Scoring," Congressional Research Service Memorandum, August 21, 2002.

[6]Gary Robbins and Aldona Robbins, "Capital Taxes and Growth," National Center for Policy Analysis, *Policy Report* No. 169, January 1992, and Gary Robbins and Aldona Robbins, "Eating Out Our Substance (II): How Taxation Affects Investment," Institute for Policy Innovation, *TaxAction Analysis Policy Report* No. 134, November 1995.

[7]Federal and state revenue systems tax income that is saved more heavily than income that is used for consumption. At the federal level, there are at least four layers of possible tax on income that is saved. (1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes). (2) But if one buys a bond or stock or invests in a small business with that after-tax income, there is another layer of personal income tax on the stream of interest, dividends, profits, or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is *the basic income tax bias against saving*. (3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder or any reinvestment of retained after-tax earnings to increase the value of the business. (Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business and create a capital gain, corporate income is taxed twice—*the double taxation of corporate income*.) (4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by *the estate and gift tax (the "death tax")*. Eliminating the estate and gift tax and the corporate tax would remove two layers of bias. Granting all saving the same treatment as is given to pensions or IRAs, either by deferring tax on saving until the money is withdrawn for consumption (as in a regular IRA) or by taxing income before it is saved and not taxing the subsequent returns (as in a Roth IRA), would remove the basic bias. Saving-deferred taxes, the Flat Tax, VATs, and retail sales taxes are examples of saving-consumption–neutral taxes. For a further explanation of the biases against saving in the current income tax, see Stephen J. Entin, "Fixing the Saving Problem: How the Tax System Depresses Saving and What to Do About It," Institute for Research on the Economics of Taxation, *IRET Policy Bulletin* No. 85, August 6, 2001, pp. 15 ff, available at *www.iret.org*. Also see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, 2nd edition, revised (Arlington, Va.: Tax Analysts, 1985).

[8]Another result was conspicuous consumption. That is, saving was affected as well. At the 20 percent interest rates then prevailing in Britain (reflecting high tax rates and high inflation), one could invest £50,000 in a government note, earn £10,000 in interest, pay £9,800 in tax, and have £200 a year left over. Alternatively, one could give up the bond and the interest to buy a Rolls Royce for £50,000 and enjoy the car. Was driving a Rolls Royce worth £200 a year? Many people thought so.

[9]Martin Feldstein, "Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates," *Review of Economic Studies*, Vol. 41, No. 4 (1974), pp. 505–513.

[10]Christophe Chamley, "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives," *Econometrica*, Vol. 54 (May 1986), pp. 607–622.

[11]Kenneth L. Judd, "Redistributive Taxation in a Simple Perfect Foresight Model," *Journal of Public Economics*, Vol. 28 (October 1985), pp. 59–83. Also see Kenneth L. Judd, "A Dynamic Theory of Factor Taxation," *American Economic Review*, Vol. 77 (May 1987), pp. 42–48; N. Gregory Mankiw, "The Savers-Spenders Theory of Fiscal Policy," *American Economic Review*, Vol. 90, No. 2 (2000), pp. 120–125; and Casey B. Mulligan, "Capital Tax Incidence: First Impressions from the Time Series," National Bureau of Economic Research, *Working Paper* No. 9374, December 2002.

[12]Andrew Atkeson, V. V. Chari, and Patrick J. Kehoe, "Taxing Capital Income: A Bad Idea," Federal Reserve Bank of Minneapolis *Quarterly Review*, Vol. 23, No. 3 (Summer 1999), pp. 3–17.

[13]Robin Boadway, "Long Run Tax Incidence: A Comparative Dynamic Approach," *Review of Economic Studies*, Vol. 46, No. 3 (July 1979), pp. 505–511.

[14]Mankiw, "The Savers-Spenders Theory of Fiscal Policy," p.120.

[15]Before van Leeuwenhoek invented the microscope, physicians knew that arteries carried blood from the heart and veins returned it, but they had no way to see the capillaries that connected the arteries to the veins. They were unable to map the full circulatory system, and many people were skeptical of the concept of a circular flow of blood. It would have been logical to assume that it was a single system in flow equilibrium, but that concept had not been invented yet. Today, many economists doubt the country's ability to finance federal deficits and the investment that is increasing the stock of capital, and to balance saving and investment, because they cannot see where the financing is to come from. They will never be able precisely to predict or trace the flow of trillions of dollars of funds throughout the complex world financial system, but the funds do flow nonetheless.

[16]Unpublished preliminary figures for a forthcoming study from The Heritage Foundation. See Gary and Aldona Robbins's earlier work for the Institute for Policy Innovation, "Eating Out Our Substance (II): How Taxation Affects Investment," *TaxAction Analysis Policy Report* No. 134, November 1995, available at *www.ipi.org*. In the IPI study, using earlier Commerce Department data that have since been revised for the period 1954–1994, the authors found that "the rate of return to new investment, after taxes, depreciation, and inflation, has been remarkably stable over the last forty years. The reason is that investors quickly counter shocks that cause their after-tax return to go up or down by changing their investment behavior. In short, increases in the after-tax return have led to an increase in the rate of capital formation until the return was driven back down to its long-run, economy-wide average of 3.4 percent [old data]. Conversely, decreases in the after-tax return have been followed by a decrease in investment until the after-tax return went back to 3.4 percent. And the adjustment generally takes five years or less. A major source of 'shock' is changes in tax policy." The revisions appear to have affected the level of the rate of return, but not the pattern of year-to-year changes or the conclusion that the public restores its desired rate of return to capital by adjusting the quantity of the capital stock it employs, and does so quickly.

[17]Adam Smith, *An Inquiry into the Nature And Causes of the Wealth of Nations*, Chapter II, 1776.

[18]Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, Vol. 86, Part 2 (April 1978), pp. S3–S27.

[19]Joel B. Slemrod, ed., *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (New York, N.Y., and Cambridge, Mass.: Russell Sage Foundation and Harvard University Press, 2000).

[20]Robert Carroll, Douglas Holtz–Eakin, Mark Rider, and Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment," Chapter 13 in Slemr

[22]Henry C. Simons, *Personal Income Taxation* (Chicago, Ill.: University of Chicago Press, 1938), p. 20.

[23]A tax on income less net saving, in which all saving is tax-deferred in the manner that current law allows for limited amounts of saving in an ordinary IRA, 401(k), or pension. This type of tax is also called an inflow-outflow tax, a consumed income tax, an individual cash flow tax, or an expenditure tax.

[24]Value-added tax, including European-style credit invoice method VATs; goods and services taxes or GSTs (as in Canada and Australia); or subtraction method VATs (also called business transfer taxes in the United States, such as is proposed in the USA Tax).

[25]A returns-exempt tax does not allow a deduction for or deferral of current saving, which must be done on an after-tax basis, but it does not subsequently tax the returns on that after-tax saving. It is the method used for Roth IRAs.

[26]See note 7.

[27]See note 7.

[28]Simons, *Personal Income Taxation*, pp. 18–20.

[29]*Ibid*., pp. 21–23.

[30]*Ibid*., p. 29.

[31]Marshall, *Principles of Economics*, p. 661.

[32]In a very fundamental sense, taxation of capital gains is double taxation of the future income of an asset. Assets have value because they provide income over time (by providing services over time for which the asset's owner is paid). In fact, the current market price of an asset is the present value of the expected after-tax future earnings of the asset (the future after-tax returns discounted to the present by an appropriate discount rate). It is the after-tax returns that are relevant because that is the only part of the returns that the owner can expect to

keep. An asset will rise in value today if there is an increase in what people expect the asset to earn in the future. If the asset does in fact earn the higher expected income in the future, that higher income will be taxed when it is earned. To also tax the rise in the present value of that increased future after-tax income stream (the present-day capital gain) is to tax the future earnings twice.

[33]See Julie-Anne Cronin, Janet Holtzblatt, Gillian Hunter, Janet McCubbin, James R. Nunns, and John Cilke, "Treasury's New Panel Model for Tax Analysis," prepared for the session on "Forecasting Government Fiscal Situations," 96th Annual Conference on Taxation, National Tax Association, Chicago, Ill., November 25, 2003; forthcoming in the proceedings of the conference.

[34]*Ibid*., p. 8.

[35]Wassily Leontief, "What It Takes to Preserve Social Equity: Amid Dynamic Free Enterprise," *The New York Times*, February 1, 1985, p. A29.

[36]U.S. Department of the Treasury, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, p. 146.

[37]*Ibid*.

[38]Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, Vol. 70, No. 3 (June 1962), pp. 215–240.

[39]If the types of business organizations, corporate and non-corporate, were equally effective in all sectors of the economy, then there would be no cross-sector reallocation due to the tax and no reduction in the returns to the non-corporate sector. Corporate businesses would merely shift the form of their organization to non-corporate, giving up whatever efficiencies (for example, ease of financing or trading ownership in a large business) that had driven them to the corporate form to begin with. They would bear the burden of the tax.

[40]See Arnold C. Harberger, "The ABCs of Corporation Tax Incidence: Insights into the Open-Economy Case," Chapter 2 in *Tax Policy and Economic Growth* (Washington, D.C.: American Council for Capital Formation, 1995), pp. 51–73. Cited lines on pp. 51–52.

[41]*Ibid*., p. 61.

[42]*IMF Survey*, Vol. 32, No. 13 (July 14, 2003).

[43]Jane Gravelle and Kent Smetters, "Who Bears the Burden of the Corporate Income Tax in the Open Economy?" National Bureau of Economic Research, *Working Paper* No. 8280, May 2001.

[44]B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, Vol. 1, ed. Lawrence H. Summers (Cambridge, Mass.: MIT Press, 1987), pp. 113–138.

[45]Gary Robbins and Aldona Robbins, "The Case for Burying the Estate Tax," Institute for Policy Innovation, *IPI Policy Report* No. 150, 1999.