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CHAPTER 13
Tax Reform as a Discovery Process

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What is the best tax structure? Neither pundits, politicians, nor economists know. Many have good suggestions for changes that would improve the tax structures we have now. But there is no best tax structure, since what is best depends on circumstances and preferences that vary over time and place. The best tax structure can only be discovered by responding to the decisions of taxpayers when they have choices among alternative tax structures. While taxpayers currently have such choices at the state and local levels, the motivation to make them, and the political response to the information they provide, are greatly moderated by the fact that the power to tax is concentrated in the federal government. With this in mind, we recommend a radical change in the fiscal environment in which taxes and spending policies that best serve the interests of those subject to them can more effectively emerge through a discovery process.

THE PROBLEM

America's fiscal problems cannot be easily dismissed. The federal and state governments impose taxes that unnecessarily burden taxpayers and distort economic decisions so politicians can cater to organized interest groups at the expense of the general public. The growth in federal spending appears to be unsustainable, given expectations of productivity growth, while it likely contributes to productivity growth falling to historically low levels. State and local governments have become increasingly compliant to the federal government to secure transfers that come with federal demands for more spending at state and local levels.

Increasingly, politicians are promising to make tough choices to restore fiscal responsibility by reforming taxes and controlling spending. They claim these reforms have to wait, however, until the weak economy strengthens, at which point the promised reforms will be largely forgotten. As Saint Augustine asked, "Lord, give me chastity and restraint, but not yet" (see Dyson 2006, 18). Until prevailing political incentives are changed, politicians will keep promising fiscal responsibility while their actions are saying, "but not yet."

We argue in this chapter that the above problems are aggravated by perverse political incentives that have resulted from the increased concentration of taxing and spending decisions in Washington. Until well into the twentieth century, peacetime federal tax receipts never exceeded 4 percent of GDP, nor were they greater than total state and local tax receipts; and in 1930, federal receipts were close to 35 percent of total government receipts. Furthermore, during peacetime, the federal budget was in surplus except during rather short recessions, when the budget deficits resulted from revenue declines, not spending increases. Since the Second World War, however, federal tax revenues have consistently exceeded state and local tax revenues, with the federal share reaching over 57 percent of total government receipts in 2009 and approximately 18 percent of GDP.[1] Peacetime federal deficits became common during the Great Depression of the 1930s and through the 1950s. They have been chronic since 1960.

A RADICAL PROPOSAL

The shift in the power to tax and spend from the state and local governments to the federal government explains much of the fiscal irresponsibility just discussed. That shift has made political rent-seeking for economically wasteful privileges and transfers easier and more profitable. These privileges and transfers take many forms, but certainly the insertion of provisions in tax codes that provide tax breaks to influential groups, industries, and even particular firms are of critical importance.[2] It is difficult to believe that tax codes full of loopholes or tax breaks do not reduce productivity by distorting economic decisions and diverting wealth-producing activities into activities to capture existing wealth. Wasteful rent-seeking is not confined to those in the private sector. State and local governments spend significant amounts to capture more money from the federal government for projects that are attractive to the recipients largely as a means of recapturing some of the federal dollars they sent to Washington and more likely than not are worth less than they cost (see Munger 2006).

That the above problems, and others, are largely the result of centralizing taxing and spending power in the federal government can be seen by considering how a radical proposal to decentralize that power would greatly reduce them. Our proposal is to move to an arrangement we call Tiebout taxation, which we believe would promote the type of fiscal federalism that Tiebout (1956) had in mind.[3] Under Tiebout taxation, federal taxation would be eliminated entirely. All tax revenue would be raised in the states, with each state required to transfer a uniform percentage of its revenue—say, 35 percent—to the federal government.[4] This fiscal arrangement is similar to that established by the Articles of Confederation, the original constitution of the thirteen United States, which was submitted for ratification in 1777, ratified in 1781, and established the rules under which the Revolutionary War was fought and won. The biggest complaint with the Articles was that the central government, being dependent on the states' voluntary contributions for revenue, was chronically underfunded.[5] Although a strong argument has been made by Sobel (1999) that the collection rate under the Articles of Confederation was as high or higher than existed under the new US Constitution, our proposal requires a specified percentage of the tax revenue raised in each state be transferred to the federal government, with this percentage being the same for all states.[6] How local tax revenue is raised would be determined in each state, and henceforth we will use the term "state" to refer to state or local (or both).

We next consider how our proposal would establish a fiscal environment that would facilitate the discovery of the tax structures most suitable for each state.

DISCOVERING BETTER TAX STRUCTURES

The most important feature of Tiebout taxation is that it would intensify competition among states. Competition among states already exists, of course. But with most tax revenue being raised by the federal government, differences in tax burdens across the states only modestly affect decisions on where to live, invest, and do business. This changes dramatically when the only tax burden comes from state taxes. Tiebout taxation would create a tax environment in which tax-base movements between states become very sensitive to relative differences in state tax burdens. Few things would concentrate politicians' minds on reforming taxes as much as significant reductions in their state's tax base as that base moves to other states. In this section, we argue that Tiebout taxation, by intensifying tax competition among the states, would motivate serious tax reform that would reduce the social cost of raising tax dollars and create a political environment that facilitates the discovery of the most appropriate reforms.

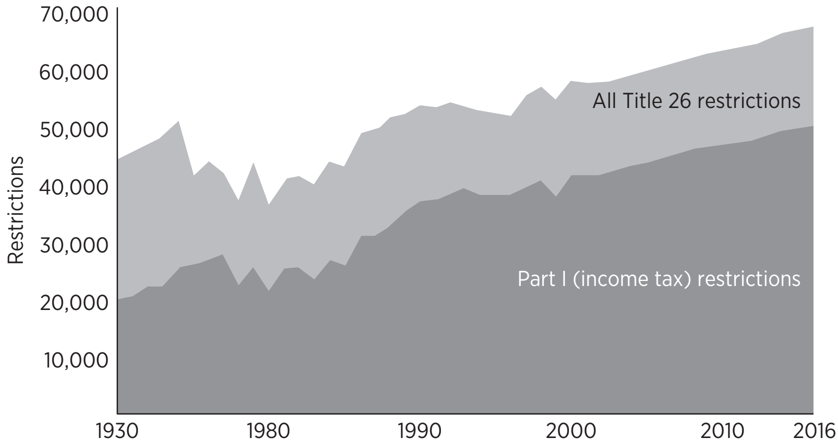
The federal tax code is riddled with thousands of special-interest complications and confusions that make it a horribly wasteful way of raising tax revenue (see chapter 19, this volume, by Matt Mitchell for more on special interests and the tax code). State tax codes are not much better, but for obvious reasons, most tax reform discussions concentrate on federal taxes.[7] The most obvious advantage of Tiebout taxation is that it reforms federal taxation by eliminating it and the over 74,000 pages of convoluted details needed to describe it (see figure 1).

Tiebout taxation greatly increases the prospects for reforming state taxation in three ways. First, it increases the political motivation in the states to reform taxes. Second, it reduces some difficulties facing serious state tax reform. And third, it facilitates a process by which a better tax arrangement can be discovered in each state.

While no one knows what the best tax system is for a state, it is not difficult to think of better tax structures than now exist at the state level. The main problem facing state tax reform is motivating politicians to consider it seriously. By intensifying competition among the states, Tiebout taxation would provide this motivation.

Tiebout taxation not only increases political incentives for states to reform their tax codes, it also reduces the difficulty of doing so. The elimination of federal taxes automatically removes an important tax distortion in all states. The federal deduction of state taxes reduces the taxpayers' cost of paying higher state taxes, which creates an obvious distortion. This deduction artificially lowers the state tax cost of services best provided privately (or not provided at all), thus making it more likely that states will provide them publicly. Consider such things as trash collection, tennis courts, golf courses, swimming pools, sports stadiums, and diversity specialists, which state governments would less likely fund without the federal government subsidizing state taxes. And education should not be overlooked. Good education at a low social cost is clearly not an advantage realized from public schools, but being able to pay for those schools

Figure 1. Income Tax Code Growth, Title 26 Restrictions, 1930–2016



Source: RegData 3.0. All data from the RegData project are available at RegData.org and the related site, QuantGov.org. Figure produced by Patrick A. McLaughlin.

Note: The RegData project quantifies numerous features of government regulation and policy and parses regulations published in the *Code of Federal Regulations* (CFR). Title 26 of the CFR contains the regulations of the Internal Revenue Service (IRS). Part 1 of Title 26 comprises IRS regulations pertaining to federal income taxes. These rules concern individuals, trusts, estates, and various types of corporations and partnerships. Part 1 details IRS treatment of these taxable entities, including the procedures for the collection of revenue, the rates at which the entities will be taxed, and the tax credits allowed under current law. Part 1 of Title 26 is the longest and most restrictive single part in the entire CFR, with nearly 9 million words and over 50,000 restrictions.

with dollars exempt from the federal income tax artificially lowers that cost. Without this tax distortion, public schools would face more competition from private schools, and the political ability of public school unions to resist school choice would be weakened.

Tiebout taxation would increase the political motivation to eliminate wasteful state tax breaks that remain after federal taxation is eliminated. Of course, interest groups would strongly oppose eliminating their tax breaks, but let us consider the costs of those tax breaks and how Tiebout taxation would intensify those costs and increase the motivation for politicians to respond to them.

A major cost of imposing taxes is what economists call the excess burden of taxation (sometimes called the dead-weight loss of taxation), which is a cost in excess of the amount of money raised. The tendency is for politicians to ignore the excess burden of the taxes and think that the cost of raising tax revenue is given by the amount raised. For example, if a dam is worth \$1.1 million and it takes \$1 million in tax revenue to build it, politicians will claim it is worth \$100,000 more than it costs. But the burden of raising another \$1 million in taxes is in excess of $1 million, because people respond to increased taxes by making investment, consumption, and labor supply and demand decisions that create less value than those that would be made without the tax increases. The marginal excess burden of a tax depends on (among other things) the type of tax, how many ways it can be legally avoided (think tax breaks), and how much tax competition the taxing jurisdiction faces. Raising another dollar with the federal income tax has been estimated to cost society between $1.30 and $1.50—a marginal excess burden of between $.30 and $.50.[8] By increasing the intensity of competition among states, Tiebout taxation would increase the excess burden of taxation and make reducing that excess burden a more salient concern of state politicians.[9]

But even if this did not motivate much political action, we can be sure the requirement that each state has to transfer 35 cents to the federal government for every tax dollar it raises to support state spending would. Each state would need to increase taxes by $1.54 (that is, $1.00 ÷ .65) for every dollar it could spend. This "excess burden" of 54 percent would be impossible for politicians to ignore, since it would represent a very visible 54 percent tax increase on every taxpayer unless serious tax reform was undertaken.[10]

Serious tax reform is not possible without expanding the tax base (reducing the number of the tax breaks) and lowering tax rates. Eliminating tax breaks and lowering tax rates work together to reduce the real excess burden of taxes in three ways. First, fewer tax breaks would result in fewer opportunities to capture tax advantages by making socially inefficient investment and consumption decisions. Second, the lower tax rates are, the less the benefit would be from taking advantage of tax breaks that remain. Third, the lower the tax rates are, the lower real excess burdens of taxation would be.[11] Also, interest groups would be more agreeable to give up their tax breaks in return for the lower tax rates if other groups were willing to give up theirs. So instead of attempting to eliminate tax breaks one by one, Tiebout taxation would likely motivate state politicians to package a large number of tax breaks for consideration, with no one break being eliminated unless all are. This creates the reciprocity needed to reduce political opposition. In other words, it is easier to eliminate the alligators by draining the swamp than by fighting one alligator at a time.

Of course, the details of the best tax structure depend on a number of considerations, such as the preferences of citizens and economic circumstances that vary from state to state. And no matter how well informed and dedicated a state's politicians and their advisors are, they have nowhere near enough information to know the tax structure that best serves the general interest of the state's citizens. Maybe the biggest advantage of Tiebout taxation over the highly centralized tax structure we have currently is that it would provide more information to decision makers on whether changes in a state's tax code are improvements and would create strong incentives for them to respond appropriately to that information. The information would come in the form of directional flows in the tax base, which would be far more responsive to tax rates and the burdens they impose on taxpayers under Tiebout taxation than they are currently. In other words, Tiebout taxation would create a discovery process that helps guide tax reform with more information and stronger incentives than exist in the present tax arrangements.

Consider, for example, federal taxes on corporate profits. The federal tax rate on corporate profits is higher than the national corporate tax rate in any other industrialized country in the world, far higher in many cases.[12] This creates incentives for American corporations to relocate to other countries and keep their profits in those countries, even though they incur a productivity loss by doing so. However, this locational distortion has not been sufficient to motivate federal politicians to make such an obvious adjustment as reducing the corporate tax rate. There can be little doubt that, under Tiebout taxation, if a state imposed the same taxes on corporate profits that the federal government does now, its politicians would quickly consider corporate tax reform seriously as their state's tax base shifted to other states.

Obviously, a move to Tiebout taxation, and the resulting tax reform, would cause significant changes in the states' tax structures. One could object to this by pointing out that a stable tax environment is desirable, because it is better to maintain an existing tax rather than constantly change it, even when the changes are to a better tax system. Changing taxes does make it harder to know what future taxes will be, which hampers making sound economic decisions. But taxes are constantly changing now, and the changes are seldom improvements. And when significant improvements are made, they are typically eroded quickly in response to political incentives. For example, the Reagan tax reforms of 1986 replaced eight tax brackets in the personal income tax with two, dropped the highest bracket from 50 to 28 percent, and significantly broadened the tax base by eliminating a large number of tax loopholes.[13] But the lower rates and broader tax base created a tax-revenue-enhancing opportunity too tempting for Congress to resist. With the elimination of a lot of tax loopholes, a tax rate increase raised more revenue than before, when ways to exempt income from taxation were plentiful. So the number of tax brackets started increasing as higher rates were added to the income tax. But, as tax rates increased, the value of tax loopholes also increased, and interest groups were willing to pay more for those tax loopholes in terms of campaign contributions and promises of support from large voting blocs. And this is exactly what happened, as predicted by Lee (1985a). Within 20 years of the 1986 reforms going into effect, the number of tax brackets had increased from two to seven and the highest tax rate had increased from 28 to 39.6 percent.[14]

The tax improvements made in response to the incentives created under Tiebout taxation could be expected to be more permanent than they would be now. Taxpayers, and tax bases, would be more responsive to the cost of taxation in their locational decisions, including the cost of changes in tax codes. Since the changes that would be made under Tiebout taxation are more likely to be agreeable to taxpayers, the changes that are made would be influenced more by changes in the circumstances and concerns of taxpayers than by the whims of politicians.

BETTER SERVICE AT LOWER COSTS IN THE STATES

We have so far emphasized the importance of tax competition among states. But neither taxing nor spending can be adequately examined without considering the other. For example, part of the motivation for tax reform under Tiebout taxation is that more efficient taxation would make it possible for a state to improve its competitive position with respect to other states by providing government services more cheaply. In this section, by focusing on spending competition among the states, we consider how intensified interstate competition motivated by Tiebout taxation would create another interaction between spending efficiency and taxing reform.

Much of the current competition among states involves each trying to free ride on the tax contributions of others by fighting over federal transfers. This competition requires (1) hiring lots of people who, instead of producing new wealth, fight over existing wealth by lobbying for federal money to subsidize costly public projects that commonly do more to promote political agendas of federal authorities than to generally benefit the state's citizens, and (2) being willing to accept federal regulations and mandates that increase the cost, and often the value, of the projects. This negative-sum competition destroys wealth in all states. If a state drops out of this competition, however, its citizens would still have to send the same amount of tax dollars to the federal government, with those dollars being spent in other states. It is understandable why each state's politicians and interest groups believe that even when the federal government is wasting taxpayer dollars, it is better to waste them in their state than somewhere else. Our current tax environment puts us all in a prisoner's dilemma in which cooperating by reducing our demand for wasteful government spending would be in the interest of all if everyone did so, but demanding more wasteful government spending is in the interest of each, no matter what others do.

Tiebout taxation reduces this prisoner's dilemma not only by intensifying competition among the states, but also by changing the competition in a way that generates positive-sum outcomes. The altered competition would still be motivated by each state's attempt to free ride on the tax contributions of other states, but with an important difference. As discussed in the next section, Tiebout taxation would create a strong incentive for the federal government to restrict its spending to providing public goods that benefit most, if not all, states. Thus, each state would have an incentive to free ride on other states by reducing its contribution for the general benefits it receives from spending by the federal government. The most effective way for a state to get such a free ride from other states would be by reducing the amount it raises in taxes, and the best way of doing this is by eliminating expenditures on state services that are not worth what they cost and providing the services that are as efficiently as possible. Of course, the free-rider advantage of more efficient spending is enhanced by the previously discussed competitive advantage achieved by reducing the cost of spending with tax reform.[15]

So under Tiebout taxation, we could expect tax reform and spending reform to reinforce each other. Of course, with all taxation taking place at the state level, and supporting both state and federal services, state taxes would increase under Tiebout taxation. But the overall tax burden would decrease, as all tax revenue would be raised and spent more efficiently than is currently the case. There is little hope for such fiscal improvement given the federal government's current power to tax and spend—a power that suppresses the tax competition among states and provides a steady stream of transfers to the states for the purpose of sustaining wasteful spending while encouraging them to increase their own tax revenues. One can reasonably think of our current fiscal arrangement as a tax cartel between the federal and state governments, making it possible for all levels of government to squeeze more money out of taxpayers and spend it with little regard to the long-run interest of their citizens.

INCREASED FEDERAL FISCAL RESPONSIBILITY

Tiebout taxation would improve the federal government's fiscal responsibility if for no other reason than the government would have less money to spend irresponsibly. In addition, it would create incentives for federal authorities to spend money more efficiently than is currently the case.

First, the incentive to avoid spending federal money to pay for services best provided by state governments or left to private provision would be palpable. If state services are worth providing, the more the federal government paid for them, the less money states would have to raise, thereby reducing the federal government's only source of revenue. If the services are not worth paying for, anything the federal government paid for them would reduce the amount it could spend on projects that would increase its revenue, which leads to the second reason for expecting more responsible federal spending under Tiebout taxation. The only way the federal government could increase its revenue, short of changing the percentage of state revenue it receives (which would require a supermajority of Congress) would be by limiting its expenditures to those services that increase general economic productivity but that are not in the interest of any one state or consortium of states to fund. In other words, the political incentives facing federal authorities would shift in favor of funding national public goods and providing them efficiently.

The US Congress would quickly recognize that providing federal money to assist state governments to pay for such things as bike paths, community swimming pools, public schools, street repairs, bullet trains, and light-rail systems would reduce its income while reducing opportunities to increase its income with expenditures that increased the prosperity of the general public. Federal politicians would also begin paying serious attention to the fact that a lot of corporate welfare reduces national prosperity and their own revenues. Fiscally irresponsible activities, such as paying farmers to grow cotton in the desert; subsidizing the production of ethanol and so-called green energy projects that often go bankrupt even with the subsidies; and bailing out failing automobile companies and their unionized workers, along with banks considered too big to fail, would lose much of their political appeal under Tiebout taxation.

When the massive federal transfer programs—such as Social Security, Medicare, and Medicaid, along with anti-poverty programs—are considered, over 60 percent of the federal budget is now devoted to transfer programs, with the largest being unsustainable as currently structured.[16] These federal transfer programs have created a growing sense of entitlement and growing dependency on government for an increasing number of things that were considered to be personal responsibilities in the past. The result is that we are moving toward a situation described by the nineteenth-century French economist, Frederic Bastiat (2012, 97), in which "*the state is the great fiction by which everyone endeavors to live at the expense of everyone else*" (emphasis in original). One does not have to believe we are about to reach such an economically destructive situation to recognize that once we are on such a path, it is easier to keep traveling down it than to make the tough decisions required for a U-turn. The longer we wait before such proposals as Tiebout taxation are considered seriously, the more difficult turning back will be.

Admittedly, making such a U-turn will require major reforms in the largest of the transfer programs (Social Security, Medicare, and Medicaid), which have grown to include far more recipients, and cost far more, than initially anticipated (or admitted) when they were enacted. This will be difficult, in large measure because of the transitional problem caused by the fact that current beneficiaries (and those workers who expect to be future beneficiaries) of the first two programs (and to a far lesser degree for Medicaid) have already earned much of their benefits by paying for the benefits received by past beneficiaries. Discussing possible ways of dealing with this transition, or other difficulties in reforming (and in some cases eliminating) other transfer programs is beyond the scope of this chapter. What we can say is that under Tiebout taxation, much of the reform would take place in the states, and politicians would be motivated to give serious attention to reforming transfer programs and spending reforms more generally. Furthermore, their reform would be aided by a discovery process making use of feedback generated by interstate competition.

Tiebout taxation has another advantage, at least from the perspective of many economists. Without going into a detailed discussion of the economic flaws and political misuse of Keynesian economics (see Lee 2012), Tiebout taxation would, for reasons that should be clear from the previous discussion, greatly reduce (if not eliminate altogether) political enthusiasm for using fiscal policy to fine-tune the economy.

CONCLUSION

Tiebout taxation is a radical proposal that will be dismissed by many as too drastic to be taken seriously. Yet we present it with the seriousness that should be given to what we see as shortsighted irresponsibility that has long characterized government taxing and spending. The fiscal incentives created by the centralization of the power to tax and spend are motivating taxing and spending decisions that are slowing, and could reverse, the growth in economic productivity necessary to sustain that power. Unless something is done, a serious fiscal crisis is inevitable.

We would be naive to believe Tiebout taxation would eliminate perverse economic policies. Taxing and spending are not the only ways the federal government can pursue political objectives that harm economic productivity. By influencing monetary policy, imposing regulations, and criminalizing economic activity, the federal government could continue attempting to fine-tune the economy, imposing inflationary taxation, transferring wealth and income, and raising funds through fines. No tax reform eliminates these problems, but this is hardly an argument for dismissing the importance of tax reform.

Also, we think putting forth the arguments for eliminating federal taxation and replacing it with Tiebout taxation is a useful exercise, even if the hope for enactment is slim. By considering our proposal, the perverse pattern of fiscal incentives that currently exists is clearly illuminated. And the reason for the harmful economic result of those incentives is seen to be the direct result of the power to tax being heavily centralized in the federal government. Other approaches to tax reform are certainly worthy of consideration. But we are convinced that for a proposed reform to be most effective it has to (1) consider the problem of discovering and motivating better tax structures, (2) recognize the importance of decentralizing taxing power, and (3) be considered seriously before a crisis is unavoidable.

We recognize, however, the tendency for politicians to continue either denying fiscal problems, or making empty promises about bringing them under control, as long as possible. This leaves the second-best hope, which is to have some reasonable options available when the problems finally have to be confronted. Friedman (2002, xiii–xiv) recognized the importance of this second-best response with the observation:

> There is enormous inertia—a tyranny of the status quo—in private and especially government arrangements. Only a crisis—actual or perceived—produces real change. When that crisis occurs, the actions that are taken depend on the ideas that are lying around. That, I believe, is our basic function: to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes politically inevitable.

We believe Tiebout taxation is an alternative that should be available for consideration when the fiscal trajectory we are currently on leads to an inevitable, and very real, crisis.

NOTES

1. Federal spending is an ever larger percentage of GDP than state and local spending, because deficits finance a larger percentage of federal spending than they do of state and local spending.
2. These tax breaks often go directly to the customers of those who lobbied, or organized the lobbying effort, with the latter receiving the benefits indirectly. Tax advantages to homeowners and the exemption of the value of employer-provided medical insurance from taxable income are examples.

3. Tiebout's (1956) theory assumes that local governments are more aware of, and sensitive to, the preferences of their citizens for type and cost of public services provided than is the federal government. Given the differences in these preferences, and the relative ease with which people can move from one local jurisdiction to another, Tiebout argues that competition among local governments will facilitate the ability of people to sort themselves into communities that best accommodate their preferences for local public services.

4. With the exception of allowing the federal government to impose a tax in case of war (with a declaration of war requiring a supermajority of both chambers of Congress), the elimination of federal taxation means no income taxes, no corporate taxes, no excise or sales taxes, and no tariffs on imports. States could not impose tariffs on imports from other states. However, if a state wanted to burden its citizens with a tariff on foreign imports, that would be allowed. Earlier versions of this idea were first developed by one of the authors: see Lee (1985b, 1996) and Buchanan and Lee (1994). This chapter has been extensively rewritten to focus attention on tax reform.

5. A detailed examination of the free-rider incentives that hampered the federal government's ability to raise revenue under the Articles of Confederation is given by Dougherty (2001). While Dougherty argues that the federal government was woefully underfunded under the Articles, he points out that funding was greater than implied by the standard model of voluntary payments for collective (or public) goods.

6. As indicated above, the federal government accounted for approximately 35 percent of total government revenues in 1929. Specifying the same percentage for all states eliminates the rent-seeking that would be the inevitable result of allowing states to transfer different percentages to the federal government. This includes tax revenues raised by local governments in each state. Although we use 35 percent in the discussion in this chapter, the actual number would be determined through a process of amending the Constitution. Also, the argument for it being the same for every state does not rule out the rate being changed a by supermajority of both chambers of Congress.

7. When state taxes are considered, it is often done to examine how they are affected by federal taxes. For example, see Bartlett (2012, chapter 13). We defer to other chapters in this volume to discuss the distortions and inefficiencies in existing tax codes in more detail than we do here.

8. See Browning (2008, 156). So the cost of the dam, once the marginal excess burden is considered, would be $1.3 million ($200,000 more than the dam is worth, even using the lowest estimate for the marginal excess burden of taxation).

9. See Laffer et al. (2014), especially chapter 1 for evidence that state tax bases are sensitive to taxpayer burdens now, where the taxpayer burden includes how much taxpayers have to pay as well as the excess burden.

10. We have put quotation marks around "excess burden," since it is not really an excess burden but a transfer to the federal government. Politicians will consider it the same as a real excess burden, however, and might overestimate the real excess burden. But since no tax reform will eliminate all political tendencies for excessive taxing and spending, it is highly unlikely that overestimating the tax cost of government programs will result in too little government spending. But even if it did, there is no reason to believe too little spending is more harmful than too much, which is surely what we have currently, with so much of the social cost of taxation being ignored by politicians.

11. The "excess burden" created by the 35 percent transfer requirement would be unaffected by tax reform. But as we shall see in the next section, this transfer requirement and the intensified competition among the states would motivate politicians to reduce spending by making more efficient spending decisions.

12. See http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates-2015.pdf.

13. However, it should be noted that after the reform, a rate of 33 percent applied to a taxable income level somewhat above the level at which the 28 percent rate kicked in and then

dropped back to 28 percent at a somewhat higher income level. Also, the reform still left plenty of loopholes in the personal income tax code.

14. See http://taxfoundation.org/blog/twenty-years-later-tax-reform-act-1986.

15. There is an elasticity issue here, since by reducing the cost of spending through tax reform, it could be efficient for a state to raise more tax dollars to spend. In this situation, the state would not be free riding on other states but taking advantage of its improved efficiency by adding to the net value of public services provided.

16. One can argue that Social Security and Medicare are not transfer programs, since a rough connection exists between the benefits a person receives and the amount he or she paid into the program. Yet there is a clear transfer element in them, since the amount paid in by beneficiaries has long been less than the amount paid out to them.

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