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CHAPTER 19
Overcoming the Special Interests That Have Ruined Our Tax Code

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THE TAX CODE IS A MESS. THIS IS NOT AN ACCIDENT

Federal, state, and local tax policy is a mess. The tax code is unjustly arbitrary, maddeningly complex, and unnecessarily inefficient. Since tax law has been written by human beings, one is tempted to wonder what motivated these misanthropes to design the system as they did. But such musings misunderstand the origins of our tax law. The tax code was not written by a single mind. Instead, it has emerged over the centuries as countless voters, politicians, and bureaucrats made public choices—large and small—that tweaked and changed the system, eventually resulting in the patchwork of tax policies we see today. To paraphrase the great Scottish Enlightenment economist Adam Ferguson, the tax code is the product of human action but not of human design (Ferguson 1782, 205).

If there is a tragic character to tax law, this is no coincidence. As the political economist Richard Wagner (2012) has noted, fiscal policy often suffers from a tragedy of the commons. The public purse is a common pool resource subject to the sort of misuse that often characterizes common property (Hardin 1968). But so too is the system of tax laws that dictate how revenue is generated.[1] If we are to overcome this tragedy, we must understand its origins. In this chapter, I outline the public choice processes that gave rise to the tax code we see today.

As the title of the chapter indicates, special interests played an outsized role in these public choices. But though special interests often dominate public policy, their perpetual hegemony is not ensured. At times, special interests can and do lose out to more general or diffuse interests. And we can learn from these episodes. Once I have sketched the various explanations for special interest domination over the tax code, I then discuss the important elements that seem to be present when special interests have lost. The goal is to give reformers hope—and direction—as they develop strategies to overcome the tragedy of our tax code.[2]

HOW DID WE GET HERE?

No one would sit down and design the tax code we currently have. It is frustratingly complex, costing us somewhere between $218 and $987 billion each year in compliance costs.[3] It is ruinously inefficient, creating an excess burden over and above compliance costs that is perhaps as much as 75 percent of the revenue it generates (Hines 2007). And it is littered with inequitable provisions that disproportionately benefit arbitrary groups.[4]

Examples of the tax code's inequity abound. And many readers no doubt have their (least) favorite illustrations. A brief tour through one aspect of the tax code—its treatment of the obscure notion of "depreciation"—will serve to make the case. When businesses incur expenses to make their products or offer their services, they are allowed to "write off" the cost of these purchases. This makes sense; if you must spend $20 to earn $100, then your income is really only $80 and only that $80 should be taxed. But what about capital purchases that wear out over time? Some economists think that firms should only be allowed to write off the cost of these purchases as the equipment depreciates or breaks down.[5] Others disagree. In their famous "flat tax" proposal, Robert Hall and Alvin Rabushka (1995) would have allowed all firms to write off the cost of long-lived purchases at the time of purchase.[6]

Both sides, however, agree that the rules ought to apply equally to all firms.[7] But the tax code's current treatment of business purchases is far from equitable. Most businesses must follow the IRS's "depreciation schedules," writing off the cost of each piece of equipment as it is believed to wear out. But a few favored industries are allowed to write off the cost of equipment faster than it depreciates, and some may even write it off immediately. Among the favored purchases are racehorses, motorsports complexes, film and television production costs, green energy property and equipment, magazine circulation expenditures, and intangible drilling costs (there are, of course, many more examples; see Joint Committee on Taxation Staff 2015, 2016; de Rugy and Michel, 2016). Because of the time value of money, these firms benefit handsomely from these accelerated depreciation rules. And because for many, accelerated depreciation is an obscure and strange concept, these privileges largely escape notice, let alone debate.

But arbitrary gains such as these come at the expense of everyone else. Tax privileges add complexity to the tax code, necessitate higher tax rates to make up for lost revenue, and cause labor and capital to be misallocated across the economy. These privileges also undermine the public's trust in the system. More than two-thirds of Americans say they are bothered "a lot" by the feeling that some corporations are not paying their fair share in taxes (Motel 2015).

Yet every arbitrary privilege and inefficient provision, every unjust imposition and time-wasting complexity was duly enacted through the democratic process. Why?

IDEAS MATTER. BUT SO DO INTERESTS

There are a lot of normative ideas about what constitutes good tax policy and sometimes differing conceptions of the public good conflict. When efficiency conflicts with equity, simplicity, or some other normative goal (e.g., paternalism), genuine disagreements arise about how to make the appropriate tradeoff in the name of the general welfare. These normative disagreements, in turn, are informed by genuine scientific disagreements about the magnitude of these tradeoffs. How much would inequality be reduced, for example, if the top personal income tax rate were raised to 50 percent and all the resultant revenue transferred to the bottom quintile of citizens?[8] And how much efficiency would be lost by such a move (Okun 1975)? Different models yield different answers. In short, there are different conceptions of the public good and different ideas about how to achieve it. What I consider to be inefficient, unjust, or overly complex, another might judge to be appropriate for the public good.

In this chapter, however, I focus on another source of bad tax law: special interests. While there is genuine debate about how to serve the public good, many provisions of tax policy only serve a narrow subset of the population.[9]

Consider the host of tax privileges, found in both federal and state law, that attend home ownership.[10] These provisions fail to serve just about every normative conception of the common good. They add complexity. They are inefficient (Horpedahl and Searles 2013). They fail to achieve their purpose.[11]

And they are regressive (Brown 2009). Those whom these rules purport to serve, homeowners, earn higher incomes and have higher stocks of wealth than the average taxpayer. But it turns out that these rules don't even serve them. Consider the mortgage interest deduction. Because the value of this deduction is capitalized into the price of homes, it simply makes home sales prices higher. Thus, it fails to help homeowners and it fails to encourage home ownership (Hilber and Turner, 2014). And yet this provision of federal and state tax policy—and many others like it—persists. Why? I offer eight explanations:

1. Rent-seeking
2. Concentrated benefits and diffused costs
3. Increasing returns to political activity
4. Logrolling
5. Bootleggers and Baptists
6. Agenda control
7. Rational ignorance and rational irrationality
8. The transitional gains trap

I discuss each in turn.

Rent-Seeking

While homeowners are not served by the mortgage interest deduction, another group is (at least for a time; see the "transitional gains trap" section below). Realtors, home builders, and financiers all gain from higher home prices. Economists call the above-normal profits that these groups earn as a result of this provision "rent." The rent is a transfer in the sense that it comes at the expense of home buyers and other taxpayers. In other words, the gain to realtors, home builders, and financiers is exactly offset by the losses of home buyers and taxpayers. But there is another cost. Those who gain from this provision invest considerable time, money, and effort in persuading policymakers to maintain it. They lobby, they donate to political action committees, and they adjust their services to satisfy policymakers. Economists call these efforts "rent-seeking."[12] And though the rent itself is a wash (one group's gains are offset by another's losses), rent-seeking is socially costly. In fact, rent-seeking societies are systematically poorer societies.[13]

Concentrated Benefits and Diffused Costs

The theory of rent-seeking predicts that those who stand to profit from special privileges will invest scarce resources in an attempt to gain and maintain those privileges. It does not necessarily predict that their efforts will be successful (indeed, rent-seeking is socially costly, in part, because many ultimately disappointed rent-seekers will nevertheless try; Tullock 1980).

Who, then, can we expect to prevail in the political struggle to obtain rent? Note that the benefits of the mortgage interest deduction are concentrated on a relatively small group, while its costs are diffused across the broader population. As a number of political scientists and economists have observed, this pattern—of concentrated benefits and diffused costs—is characteristic of much public policy (Olson 1965; Lowi 1969; Wilson 1991). The economist Mancur Olson explained why in his classic text, *The Logic of Collective Action*. All collective action, he observed, is difficult. It takes time, money, and effort for a group of like-minded or like-interested people to persuade policymakers to pursue a particular course of action. What's more, each member of the group has an incentive to free ride on the efforts of others. This incentive discourages everyone from acting. For this reason, most of us who stand to gain by banding together and lobbying for a particular policy never get very far.

Olson observed, however, that small groups have an easier time overcoming these problems than do large ones. First, being fewer in number, the per-person benefit of collective action is greater in small groups than in large groups. Second, it is easier to coordinate the activities of a small number of people than it is to coordinate those of a large number.[14]

For these reasons, small, concentrated groups like realtors, developers, and lenders often have an organizational advantage over large, diffuse groups like consumers, borrowers, and taxpayers. This tends to result in such policies as the mortgage interest deduction, which concentrate benefits on the few while diffusing costs across the many.

Increasing Returns to Political Activity

The organizational advantages that small concentrated interests enjoy tend to grow with use. In a penetrating analysis of corporate political activity, Lee Drutman (2015) has found that once firms decide to engage in politics, they tend to stay engaged and often expand their activities. The marginal costs of lobbying fall, while the marginal benefits increase; in other words, there are economies of scale in political activity.[15] In the case of tax law, the returns to political activity can be extraordinary. One study examined the lobbying activity surrounding a provision in the American Jobs Creation Act of 2004, which permitted a tax holiday on repatriated earnings (Alexander et al. 2009). The researchers found that for every $1 spent on lobbying, firms reaped a $220 tax benefit. This is equivalent to a 22,000 percent rate of return. In a more general study of the relationship between lobbying expenditures and tax liability, researchers found that a 1 percent increase in lobbying expenditures was associated with a 0.5–1.6 percentage point reduction in a firm's effective tax rate (Richter et al. 2009).

Once the tax laws have been written, some firms are better than others at taking advantage of its loopholes. In 2010, for example, General Electric filed a 57,000-page federal tax return that enabled it to pay $0 in taxes on $14 billion in profits (McCormack 2011). Only a wealthy and sophisticated company with an army of accountants could pull off such a feat.

Logrolling

Though small groups have some political advantages compared with large groups (especially if they have been at it for some time), they must still gain the assent of a majority of state or federal legislators to achieve their public policy goals. The practice of "logrolling," or vote-swapping, facilitates this.[16] When legislators logroll, each agrees to vote for the other's interests. In this way, a majority coalition can be assembled whereby each member agrees to support the (concentrated) interests of every other member of the coalition (Tullock 1959; Riker and Brams 1973; Riker 1984). Costs may then be externalized onto the minority, much as a polluting factory externalizes part of its production costs onto its neighbors.

Though anecdotal accounts of logrolling are as old as democracy, it has also been documented in more formal analyses. Professor Thomas Stratmann (1992, 1995), for example, has found that members representing dairy and sugar interests tend to vote for peanut interests, and vice versa. Logrolling is also evident in large bills that tie together multiple interests. Consider, again, the 2004 American Jobs Creation Act. This sprawling 650-page bill contained targeted tax benefits for NASCAR track owners, tobacco growers, Native Alaskan whaling captains, film producers, and manufacturers of everything from archery equipment to sonar fish finders to tackle boxes (Drutman 2015, 127).[17]

Bootleggers and Baptists

Superior organizational ability and well-constructed legislative logrolls are helpful. But it also helps to have a good story. Thus, it is quite common for those seeking special tax, spending, or regulatory privileges to claim that these special favors serve the general welfare. In some cases, these groups even form strange bedfellow coalitions with publicly spirited groups. Regulatory economist Bruce Yandle coined a term for this phenomenon, calling it the "Bootleggers and Baptists" theory of regulation (Yandle 1983; Smith and Yandle 2014). The term gets its name from the strange bedfellow coalition of bootleggers and religious groups who advocate for laws banning the sale of alcohol on Sundays. Bootleggers value these laws because they offer relief from legal competition one day a week. And religious groups value them because they promote abstention on the Lord's Day.

Thus, the mortgage interest deduction is not sold as a way to pad the pockets of realtors. Instead, it is said to promote "an ownership society." Film tax credits are not a wasteful privilege to a flashy industry. They are a smart way to promote "economic development." And tax exemptions for bonds issued to finance sports arenas are not giveaways to wealthy and well-connected team owners. They are a means to "redevelop" urban corridors.

Agenda Control

An important but rarely discussed quirk of democratic decision-making helps special interests dominate the political process. First discovered by an eighteenth-century French aristocrat, the Marquis de Condorcet, the idea was also explored in the nineteenth century by Charles Dodgson, better known as Lewis Carroll (Condorcet 1785; Dodgson [1876] 1958). The modern iteration of the problem was explained by economists Duncan Black and Kenneth Arrow in the middle of the twentieth century (Black 1948; Arrow 1951). Here is the problem: When two policies are considered at once or when one policy has multiple dimensions to it (and just about every issue in politics is multifaceted), those who control the order in which votes are taken can determine the outcome.[18] In most modern legislatures, party leaders and committee chairs determine the order in which votes are taken (which is one among many reasons these positions are so coveted by members). By controlling the agenda, these leaders are able to ensure the victory of their most-preferred outcome (McKelvey 1976).

As the political scientists Peter Bachrach and Morton Baratz (1962) have argued, agenda control is as much about keeping certain items *off* of the agenda as it is about putting items on it. In other words, those who wield true power in politics use it to ensure that certain items, such as removal of tax privileges, are simply never brought up for discussion. And that is the way special interests want it.

Rational Ignorance and Rational Irrationality

In many cases, those with political power do not have to work hard to make sure that removal of special interest privileges remains off the agenda. That is because most of the public is "rationally ignorant" about these policies. Rational ignorance may at first sound like an oxymoron, but it is not. It takes time, money, and effort to become informed on any subject. And given that each of these commodities is scarce, rational humans will be selective in how they choose to inform themselves. Most of us will choose to become informed on a topic only when the benefits of gathering information exceed the costs. This is why most of us know very little about the anatomy of the mongoose.

In a typical election, the probability that any one vote will sway the outcome is minuscule (Gelman et al. 2009). Given this, little is to be gained by becoming informed on the issue. Hence, as the political economist Anthony Downs (1957) explained many years ago, most voters are rationally ignorant on most matters of public policy.

Even when voters do have an incentive to gather information about an issue, they often have little incentive to process that information. Consider, again, the mortgage interest deduction. Homeowners have a strong incentive to know about the existence of this provision, because it can save them thousands of dollars on their tax bills. Few, however, take the time to study the economic theory of tax capitalization and therefore do not realize that this provision also raises the price that they paid for their home in the first place. Economist Bryan Caplan (2008) coined the term "rational irrationality" to describe this failure to think through the implications of policy.

The special interests who benefit from privileges, of course, do not suffer from either rational ignorance or rational irrationality. They have every incentive to know about and think critically about the policies from which they benefit. They even have an incentive to purposely obfuscate policy in order to keep large and diffuse interests in the dark (Zingales 2011, 203). This explains why they prefer obscure privileges, such as accelerated depreciation, to more conspicuous privileges, such as cash subsidies.

The Transitional Gains Trap

There is an irony to the market for political privilege. Privileged firms only seem to reap extraordinary profits during the transition period in which they gain the privilege. Over the long run, though, these privileged firms and industries tend to fare no better than others. Gordon Tullock (1975), who was the first to observe this phenomenon, offered a compelling explanation for it. He suggested that firms often need certain assets to obtain privilege. For example, taxi operators must have a medallion to enjoy the regulatory privilege of operating with limited competition. Similarly, farmers must have land to obtain farm subsidies. And other rent-seekers must have a well-connected lobbying team to access politicians dispensing favors. Tullock noted that, over time, the value of the rent tends to get capitalized into the value of these assets, driving up the cost of medallions, farmland, and lobbyists. Thus, to obtain above-normal profits, firms must undertake above-normal expenses. Net of these expenses, the long-run return to rent-seeking is no greater than a normal rate of return. In the words of David Friedman, "the government can't even give anything away."[19]

This insight has important—and depressing—implications for the elimination of privilege. Because privileged firms are no better off for their privileges, the elimination of their special treatment threatens to impose a significant loss on them. This makes them willing to fight tooth and nail to avoid these losses (McCormick et al. 1984; Shughart 1999).

HOW CAN WE OVERCOME SPECIAL INTERESTS?

Special interests clearly play an outsized role in the formation of public policy. Their mark on the tax code—which features special privileges for agribusinesses, film producers, sports teams, relocating firms, and many more—can hardly be denied.

And yet sometimes special interests lose. Consider just a few examples:

For centuries, an elite group of white slaveholders benefited from the "peculiar institution" of slavery. The Civil War and the Constitutional amendments that followed put an end to the worst of these privileges, liberating approximately 3.9 million slaves. It would take another century, but the last legal privileges of southern whites eventually were eliminated as well.

Under the Articles of Confederation, state governments could protect local merchants from competition by imposing discriminatory duties on interstate trade. When it was adopted in 1789, the new Constitution outlawed such protectionist measures, eventually allowing the United States to become the largest free trade zone in the world, much to the benefit of American consumers.

In the early years of the Republic, certain merchants profited from discriminatory regulatory measures imposed by state and local governments. But eventually these were struck down in a US Supreme Court case that one historian would call the "Emancipation Proclamation of American Commerce."[20]

For much of the nineteenth century, the patronage system ensured that federal jobs were dispensed on the basis of personal connection and political corruption. But a series of civil service reforms ended the worst of these practices.

For most of US history, American consumers paid an exorbitant price for the protectionist privileges afforded domestic manufacturers. In 1932, the average tariff on dutiable imports was over 59 percent. Today it is less than 5 percent, and global trade is freer than ever (US International Trade Commission 2011).

In the 1970s, airlines, freight railroads, and truckers benefited from a wall of regulations that protected them from competition. But deregulation opened these industries up to competition, vastly improving the consumer experience (Morrison and Winston 1986, 1989).

In the latter half of the twentieth century, communities with strategically obsolete military installations were able to apply pressure to maintain these bases, even when military leaders said they were unnecessary. But through the Base Realignment and Closure (BRAC) process, 350 bases have been closed, saving taxpayers millions of dollars (Brito 2011).

These episodes do not disprove the public choice lesson that special interests often dominate political processes. But they suggest that there are exceptions to the rule. Moreover, on closer examination, we find that these exceptions display certain patterns. While no one is likely to wage a civil war over the mortgage interest deduction, those who are interested in eliminating the special interest privileges in our tax code—and elsewhere in policy—can learn from these episodes. Seven lessons stand out:

1. Ideas matter, especially in the long run.
2. Institutions matter, too.

3. Go for the "grand bargain."
4. Reform requires good leaders.
5. Sometimes it takes a special interest to beat a special interest.
6. Never let a crisis go to waste.
7. Embrace permissionless innovation.

Drawing on historical case studies, I briefly touch on each of these in turn.

Ideas Matter, Especially in the Long Run

I began this chapter by noting that bad ideas are not the sole source of bad tax law. Sometimes, inefficient and inequitable policies are enacted because special interests favor them.

But this is not to say that ideas are unimportant. In their insightful study of social change, Edward López and Wayne Leighton (2012) note that John Maynard Keynes and F. A. Hayek—intellectual antagonists on so many issues—agreed on at least one point: over the long run, ideas shape history. Keynes (1937, 328) wrote of the "academic scribblers" whose ideas eventually influence kings and world leaders, even though the latter are "practical men who believe themselves quite exempt from any intellectual influence." Hayek (1949, 417) described the mechanism by which the ideas of academic scribblers are turned into social change, emphasizing "intellectuals," those "secondhand dealers in ideas" who refine, distill, and ultimately sell the ideas of the academic scribblers to their fellow citizens.

The abolitionist movement, the free trade movement, and the (short-lived) deregulatory movement of the late 1970s were intellectual ideas before they were anything else. Their origins, which predated policy change by years and sometimes decades, are in the writings of such scribblers as William Lloyd Garrison, Frederick Douglass, Harriet Beecher Stowe, Sojourner Truth, David Ricardo, Adam Smith, J. S. Mill, John Bright, Richard Cobden, Milton Friedman, F. A. Hayek, Ronald Coase, James Buchanan, George Stigler, George Douglas, James Miller III, and Alfred Kahn. The arguments that these men and women put forth eventually overcame the array of advantages enjoyed by the special interests who opposed them.

But it is important to note the *sorts* of ideas that seem to take hold. As Alex Tabarrok (2002, 3) has observed, "no one goes to the barricades for efficiency. For liberty, equality or fraternity, perhaps, but never for efficiency." Tax reformers should take note that equity, in particular, is a powerful idea. Despite what you may remember from seventh grade, colonial anger over the Tea Act of 1773 erupted not because it was a tax increase (it was not), but because it was a tax cut for one and only one company, the East India Tea Company. Similarly, while the inefficiencies of airline regulation had long been discussed by economists (Douglas and Miller 1975; Jordan 1979), the political impetus for deregulation in the late 1970s was driven by a series of congressional hearings that exposed the inequitable and anticompetitive effects of regulation (McCraw 1984, 267). Of particular relevance for tax reformers, the Tax Reform Act of 1986 (TRA-86) was spurred in part by reports that 128 major corporations availed themselves of tax loopholes to avoid paying any federal corporate income tax at all (Murray and Birnbaum 1988, 12). Thus, the idea of lowering rates and closing loopholes took hold, appealing to such ideologically diverse "practical men" as Dan Rostenkowski, Bill Bradley, and Ronald Reagan.

Institutions Matter, Too

The Tax Reform Act of 1986 (TRA-86) was an impressive feat on many levels. It closed scores of loopholes and exemptions, each of which had a powerful constituency defending it. But within a few years, most of these special interest provisions (and many more) were back. That is because TRA-86 had no mechanism to prevent backsliding. It did nothing to change the incentives of politicians to dispense targeted privileges to concentrated interests, and so they kept on doing so. The 1986 winner of the Nobel Prize in economics, James Buchanan, theorized that some policymakers may have even voted for TRA-86 to wipe the slate clean and then offer to "renegotiate" new loopholes. "In one fell swoop," he wrote in 1987, "the political agents may have created for themselves the potential for substantially increased rents. This rent-seeking hypothesis will clearly be tested by the fiscal politics of the post-1986 years. To the extent that agents do possess discretionary authority, the tax structure established in 1986 will not be left in place for decades or even years" (Buchanan 1987, 33–34).

This sort of backsliding is not inevitable, however. And institutions, which Douglass North (1990, 3) defined as "the humanly devised constraints that shape human interaction," are one reason why not.

As I noted earlier, the average US tariff on dutiable imports fell from more than 59 percent in 1932 to under 5 percent today, and, with few exceptions, these rates have remained low. Much of this decline can be credited to the institutional changes wrought by fast-track trade negotiation and the World Trade Organization.

Franklin Roosevelt's Secretary of State, Cordell Hull, was an early champion of fast-track trade negotiation. Like most southern Democrats at the time, Hull was a free trader (Zeiler 1999, 7). But as a former member of Congress, he believed that the problem with trade policy was that it was in the hands of Congress. The typical member of Congress, he reasoned, was moderately in favor of more liberalized trade but wanted an exception for whatever product happened to be made in his or her district. This meant that any free trade deal struck by a president was liable to be picked apart by representatives and senators seeking to protect their hometown companies. Hull's idea was for Congress to give the president the authority to negotiate a tariff reduction agreement with other countries while Congress would bind itself to an up-or-down vote on the deal and not amend any part of it. The institutional innovation was known as the Reciprocal Tariff Agreement Act (RTAA). Over time, the idea came to be known as "fast-track trade negotiation."

This achieved two things. First, in voting for fast-track trade negotiation, the typical member of Congress was able to cast a conspicuous vote in favor of the general interest. Second, in pushing the details of the deal off on to the president, the typical congressman was able to obtain some cover in voting against his or her hometown special interests. Presidents, of course, are susceptible to special interest pressures, too (Stratmann and Wojnilower 2015). But because a president represents the entire nation, it is not as easy for him or her to externalize the costs of special interest privileges on to others (Lohmann and O'Halloran 1994).

Similar institutional incentives have facilitated other special interest clawbacks. BRAC commissions work the same way (Brito 2011). When an individual member of Congress votes for BRAC, he or she is able to cast a conspicuous vote in favor of cutting unnecessary military spending. But the commission itself decides which particular bases to close, allowing the member whose hometown base is closed to tell constituents that her hands were tied. In fact, congressional members with bases in their districts are invited to come before the commission and plead their cases, giving them extra cover before their constituents. The key, as former Representative Dick Armey told me in an interview, was that individual members were spared the blame: "When you fail to save your base, your failure won't be held against you."[21]

While some institutions such as fast-track trade negotiation and BRAC offer policymakers an incentive to serve the general interest (and cover when taking away privileges from special interests), other institutions "lock in" changes once they have been made, reducing the incidence of backsliding. The World Trade Organization, for example, polices free trade agreements by allowing members to file formal complaints when other signatories renege on the promises they have made. Thus, when the United States is found guilty of subsidizing its domestic cotton producers (to the detriment of US taxpayers and international producers) or of protecting domestic steel, tire, magnet, paper, chemicals, flooring, wind turbine, and kitchen fitting manufacturers (to the detriment of US consumers and foreign producers), it must either pay a fine or reverse policy course (Pelc 2014).[22]

The US Constitution itself is an institutional device that mitigates the power of special interests and prevents backsliding into special interest privilege. Article I, Section 10's provision that "No State shall, without the Consent of Congress, lay any Imposts or Duties on Imports or Exports" has, in effect, created the world's largest free trade zone (Riker 1964). Similarly, for more than half a century, the General Welfare Clause was understood to limit Congress's ability to appropriate funds for the benefit of special interests (Eastman 2001).

Ideas and institutions interact in complex ways. As many institutional theorists have noted, some of our most important and enduring institutions are informal norms, ideas, and practices (Boettke et al. 2008; Williamson 2009). And even formal institutions can be ignored if they are not widely seen as legitimate (Ferejohn et al. 2001).

But the historical lesson is clear for tax reformers: if they wish to make the tax code more general and less particularistic and if they wish to prevent backsliding into particularism, they will need to bind the hands of future policy makers through constitutional or institutional constraints (Buchanan 1990, 2000).

Go for the "Grand Bargain"

The prisoners' dilemma of game theory is an apt description of special interest politics.[23] Consider table 1. Imagine that two special interests each have an option to seek a privilege through the tax code. If neither seeks a privilege, each has a net tax burden of $0.00. If one seeks a privilege while the other abstains, then the privilege-seeker obtains a net tax benefit of $2.00 while the abstainer pays a net burden of−$1.00. If both seek privileges, however, then each bears a burden of−$0.50 (not $0.00, because taxation involves deadweight loss and privileges entail a host of economic costs; Mitchell 2012). In this scenario, privilege seeking is a dominant strategy. That is because no matter what B does, A always has an incentive to seek privileges and vice versa (if B seeks no privileges, A has an incentive to seek privileges, because $2.00 is greater

Table 1. Special-Interest Politics

		Special Interest B			
		Seeks No Privileges		Seeks Privileges	
Special Interest A	Seeks No Privileges	A gets:	B gets:	A gets:	B gets:
		$0.00	$0.00	–$1.00	$2.00
	Seeks Privileges	A gets:	B gets:	A gets:	B gets:
		$2.00	–$1.00	–$0.50	–$0.50

than $0.00; and if B does seek privileges, then A still has an incentive to do so, because losing $0.50 is better than losing $1.00).

Acting independently, both A and B are doomed to seek privileges, and both will end up losing $0.50. It is the anti-Adam Smith theorem: in seeking his own interest, each is impelled as if by an invisible hand to undermine the public interest.

But if the two special interests could somehow cooperate, they could avoid this fate. Institutions—rules—can facilitate such cooperation. In a fascinating study called *Politics by Principle*, James Buchanan and Roger Congleton (1998) examine the consequences of a simple and normatively intuitive rule: the generality norm. This rule states that public policy can take any form so long as it is nondiscriminatory. No individual or group may be singled out for either special privilege or special punishment. In terms of the game-theoretic model described above (see table 1), the generality norm would constrain the participants to the shaded diagonal cells; either both may have their privilege or neither may. Thus constrained, the rational course is for neither to seek a privilege, which happens to be the most efficient outcome.

The practical lesson for reformers hoping to eliminate special interest privileges is to "go for the grand bargain." If you take away any one group's special privilege, they are sure to put up a strenuous fight. But people may not mind having their ox gored so long as everyone else's ox is gored as well, thus reducing one's share of ox-upkeep costs. This is not just theory. TRA-86 eliminated special interest loopholes and used the tax savings to reduce tax rates across the board. Special interests were willing to give up some of their favors so long as others did so as well, allowing the rates everyone paid to fall. Similarly, multilateral tariff reduction agreements, such as NAFTA, are able to achieve freer trade because all interested parties are willing to give up their protections.

Reform Requires Good Leaders

Grand bargains align incentives so that it is in everyone's interest to eliminate privilege. But they are extraordinarily difficult to achieve. This is because bargains involving multiple parties have extraordinarily high "transaction costs." Not to be confused with the terms of trade—the price one pays in an exchange—transaction costs are the cost of finding a willing party with whom to exchange, striking a bargain with him or her, and enforcing that agreement (Coase 1937; Williamson 1979). Transaction costs tend to rise as the number of parties to an agreement rise. And they tend to be higher in political settings than in commercial settings, because there is typically no one to enforce a political agreement (Dixit 1998; Acemoglu 2003).

This is why leadership matters. Leaders are coalition builders who set the agenda and assemble the grand bargainers (Douglas 1990). Often, their efforts prod others to contribute to the public good (Houser et al. 2014). And in so doing leaders are also institutional entrepreneurs who create and modify the institutional framework (North 1990, 83–84).

In every instance I can find where a special interest has lost its privilege, a leader has played a key role. Madison proposed the institutional change and assembled the grand bargain ensuring that the Constitution prohibited interstate barriers to trade (e.g., see Madison 2000). Cordell Hull developed the idea of fast-track trade negotiation but sold it to Franklin Roosevelt, who then saw it into law (Zeiler 1999, 7). Alfred Kahn (with an assist from Ted Kennedy) led the effort to deregulate airlines (McCraw 1984). Representative Dick Armey and Senator Phil Gramm led the creation of BRAC. Senator Bill Bradley, Representative Dan Rostenkowski, and President Ronald Reagan championed the effort to reform taxes in 1986. It is difficult to imagine these efforts succeeding without the work of those leaders.

Sometimes It Takes a Special Interest to Beat a Special Interest

A charismatic leader with the right idea can assemble a coalition and urge his or her followers to take collective action to support the cause. He or she can also appeal to the better angels of their nature the way "Baptists" do in the "Bootleggers and Baptists" model.

But what leaders have in charisma and moral high ground they often lack in organizational and financial resources. Even the most charismatic leader could use the help of a bootlegger. And that is where other special interests come in. While Olson's theory predicts that concentrated interests often will prevail over diffuse interests, a concentrated interest sometimes exists whose motives happen to align with those of more diffuse interests. And this can be very helpful in overcoming other special interests.

Consider the slave trade. Politically powerless, American slaves had no way to exert direct influence on public policy. Yet as soon as the Constitution permitted it (in 1808), Congress outlawed the importation of slaves. Humanitarian organizations, such as the Pennsylvania Abolition Society, played an important role. But these "Baptists" (they were actually Quakers) were aided and abetted by a highly organized and politically potent group of "bootleggers": mid-Atlantic slaveholders (Anderson et al. 1988). As net exporters of slaves to other colonies, the large slaveholders of the mid-Atlantic could command a higher price for the slaves they sold once the overseas supply was eliminated. This made these politically powerful men important advocates for the elimination of the overseas slave trade. It was a happy coincidence that slaves who would have otherwise been imported as well as American slaves, who were likely treated somewhat better since they could not be as easily replaced by new imports, also benefited.

Decades earlier, when James Madison won his victory for consumers by ensuring that the Constitution outlawed duties on interstate trade, he too had assistance from a concentrated interest group. Farmers who exported their surplus crops across state lines (Madison himself was one of them) were often a powerful voice for free trade among the states, and they proved to be powerful advocates for this provision in the Constitution (McGillivray et al. 2001).

In general, exporters have often been advocates of free trade, as reciprocal free trade agreements give them access to new and larger markets. In the years after the RTAA passed, exporters became important advocates for free trade (Hiscox 1999). Typically, their interests are aligned with those of consumers, but being fewer in number and more concentrated, they are not as hamstrung by the collective action problem.

Decades later, when exporters found themselves defending their own privilege, another concentrated interest group sided with the general interest to oppose them. In 2015, the long-ignored Export-Import Bank (Ex-Im) came up for congressional reauthorization. This federal agency risks taxpayer dollars to help finance exports for foreign buyers (de Rugy and Castillo 2014). Only about 2 percent of all US exports receive aid from the agency, and a majority of the assistance goes to just ten large firms (over 35 percent goes to Boeing alone; de Rugy 2015a,b). The agency shifts risk on to taxpayers, siphons capital from other projects, and raises the prices of some goods (Ikenson 2014; Mitchell 2014). The costs of the bank exceed its benefits (Beekman and Kench 2015). But since taxpayers, borrowers, and consumers are far more numerous and diffuse than the handful of exporters who benefit from Ex-Im, the agency has outlasted thirteen presidents and thirty-nine Congresses.

The year 2015, however, was different. For the first time in its 80-year history, the bank's congressional charter lapsed. Those whom Keynes would call scribblers and Hayek would call intellectuals, such as my colleague Veronique de Rugy and journalist Tim Carney deserve a great deal of credit for this achievement.[24] But they were aided by a concentrated interest, Delta Airlines. Delta, it turns out, is harmed by Ex-Im in two ways. First, because Ex-Im's subsidies increase the demand for wide-body aircraft, the agency raises the cost of airplanes. Second, because it subsidizes foreign airlines, such as Air India, Delta has more difficulty competing along some foreign routes. Thus, Delta was a highly organized and effective advocate for the elimination of the bank.[25]

The lesson for tax reformers is that they will have an easier time serving the general interest if they can find some concentrated interests who might gain from tax reform. Who might this be? One suggestion is any group that is currently singled out for particularly harsh tax treatment. This includes the purveyors of inelastically demanded goods, politically incorrect goods, goods that are taxed by multiple overlapping jurisdictions, or goods that are primarily sold to nonvoters, such as out-of-town tourists.

Never Let a Crisis Go to Waste

As has been noted many times by many different and disparate voices, radical institutional change is sometimes advanced by external forces. This is what Milton Friedman (1962, xiv) meant when he asserted that "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." Years later, President Obama's chief of staff, Rahm Emanuel, would echo this sentiment, asserting in the midst of the financial crisis of 2009 that "you never want a serious crisis to go to waste. And what I mean by that is [that it's] an opportunity to do things you think you could not do before."[26]

The political economist Robert Higgs (1987) wrote an insightful and revealing book detailing the role that crises have played in the growth of American government. But crises and other external events have also played a role in the elimination of special interest privilege.

Regardless of how it began, the smartest of the abolitionists—including, in the end, President Lincoln—understood that the Civil War had to conclude as a war to end slavery. And though slavery might have ended in other ways, the abhorrent institution and the extraordinary privilege it afforded southern slaveholders was ended by a crisis.[27]

A generation later, a different crisis furnished a reason to do away with a different privilege. For much of the nineteenth century, political parties overcame their collective action problem by offering selective benefits to those who contributed to their cause. The most common of these benefits was public office. Long detested, this patronage or "spoils system" had withstood countless reform efforts. Then, in 1881, President James Garfield was assassinated by a disappointed office seeker who felt slighted that his campaigning for the president had not bought him a high profile position in the Garfield administration. The event galvanized support for civil service reform and prompted Garfield's successor, Chester A. Arthur, to become an unlikely champion of the cause (Millard 2012, 289). Civil service reform was accomplished through an institutional innovation, civil service exams, which introduced a measure of competition in federal hiring.

The Second World War was the crisis that abetted free trade. The war had decimated foreign exporters, giving a boost to American exporters, who, as already discussed, tended to favor free trade. It so happened that these exporters largely were located in northern, mostly Republican, districts. This is important because, for the better part of a century, the Republican Party had been held together by the high tariff plank of its platform. With exporters suddenly emboldened in Republican-leaning districts, the party's longstanding opposition to free trade began to whither (Hiscox 1999).

In the 1970s, a macroeconomic crisis aided the cause of deregulation. For decades, the Civil Aeronautics Board had shielded air carriers from interstate competition (Jordan 1979). Unable to compete over price, airlines resorted to nonprice competition, which tended to raise costs (Douglas and Miller III 1975). Consumers were stuck with the bill for this regulatory protection, but as previously noted, it typically is difficult to organize a large and diffuse group, such as consumers, for collective action. The 1970s, however, were not typical times. The Federal Reserve's expansion of the monetary base by 25 percent between 1974 and 1976 had yielded double-digit inflation (Smiley 1993, 218). This meant that voters and politicians were unusually interested in price levels. Unpersuaded by Milton Friedman's (1970, 11) assertion that inflation was "always and everywhere a monetary phenomenon," policymakers took a keen interest in eliminating any policy that might be causing high prices. President Ford created the Council on Wage and Price Stability, and Senator Kennedy began holding hearings investigating the role of the Civil Aeronautics

Board in fixing airline prices. Alfred Kahn parlayed this interest in prices into sweeping deregulation of the airlines (McCraw 1984).

From 1980 to 1988, the national debt nearly tripled. Though it seems quaint to say it now (with federal debt more than six times 1988 levels) many policymakers and pundits worried at the time that the national debt had reached crisis proportions. Thus, when Senator Phil Gramm and Congressman Dick Armey proposed BRAC as a way to reduce unnecessary military spending, their proposal was well tuned to the crisis du jour.

Embrace Permissionless Innovation

The economist David Henderson has observed that "competition is a hardy weed, not a delicate flower." (Henderson 2012) Try as they might to shield themselves from the gales of competition through government privilege, firms must always be wary of competitors. As Bruce Benson (2002, 248) has observed, entrepreneurs in highly regulated industries have "incentives to explore all uncontrolled or ineffectively enforced margins."

This can push institutions in one of two directions. The first—and apparently most common—is toward ever-expanding intervention. Alfred Kahn described it in the context of airline regulation:

> Control price, and the result will be artificial stimulus to entry. Control entry as well, and the result will be an artificial stimulus to compete by offering larger commissions to travel agents, advertising, scheduling, free meals, and bigger seats. The response of the complete regulator, then, is to limit advertising, control scheduling, and travel agents' commissions, specify the size of the sandwiches and seats and the charge for inflight movies. (quoted in McCraw 1984, 272)

The dynamic can also lead to regulation of additional industries. In this way, regulation of railroads begot regulation of trucking, which begot regulation of airlines (Hilton 1966).

Institutions might respond to dynamic competition in a second way. They might become more liberalized, especially if dynamic competition is strong enough. Sam Peltzman (1989), for example, showed that technological change (the widespread adoption of jet-powered aircraft) altered the composition of the political coalition behind airline regulation, leading the regulator to permit more service competition. Similarly, Diana Thomas (2009) documents the way disruptive technology in the fifteenth-century German beer industry—they began using hops instead of *grut*—created an end-run around existing regulatory privileges. This was possible because the older technology had been central to the way the regulatory privileges worked: "During the eleventh century, the Holy Roman Emperor awarded local monopoly privileges in the production and sale of *grut*" (Thomas 2009, 333). Once that ingredient was no longer needed, the regulatory privilege crumbled.

A similar dynamic is occurring today in urban transportation markets. Uber, Lyft, and other sharing economy firms have developed business models that are so different from the existing taxi models that many regulations protecting taxi operators from competition simply do not apply (and when regulators assert that they do apply, the ride-sharing firms often have ignored them).

There are two lessons here. First, disruptive technologies and a culture that embraces what Adam Thierer (2014) has termed "permissionless innovation" can challenge existing privileges. Second, the opportunity for such a challenge is ironically greatest when regulatory privileges are most stifling, locking in particularly inefficient and outdated technologies.

CONCLUSION

Ever since Madison warned about the power of "faction" in Federalist 10—and probably well before then—people have been complaining about the outsized influence of special interests. Public choice theory and data suggest that these concerns are well founded. Small, well-heeled, and well-organized interests are often able to win public policies that concentrate benefits on themselves and foist the costs on others. Federal, state, and local tax policy provides numerous examples.

And yet there are exceptions to the rule. Occasionally, diffused and general interests prevail over concentrated and special interests. Moreover, certain patterns seem to mark these exceptions. These patterns suggest some rules of thumb for reformers hoping to overcome the special interests who have carved up our tax code.

But it is prudent to end on a note of caution. Every pattern I identify here could be used by special interests to obtain privilege, just as it could be used by reformers to serve the general interest. There is no guarantee that ideas will be good ones (think of the human misery wrought by Marx's ideas). Nor can we be certain that institutional change will always be for the better. Some of the institutions I have discussed, such as BRAC and fast-track trade negotiating authority, concentrate power in the executive, since the executive's constituency is typically more diffuse than that of individual legislators. But executives, too, are susceptible to special interest suasion, and too much power in the executive can be dangerous. A "grand bargain" may untie the Gordian knot of the tax code if every special interest agrees to give up its privilege in exchange for every other interest doing the same. But large, multifaceted bills are also a good way to facilitate special-interest-serving logrolls. Leaders can rally the public around the general interest, assemble grand coalitions, and improve institutions. But charismatic leaders with great power can, of course, do great harm. It goes without saying that working with special interests to defeat other special interests can sometimes backfire.[28] And, of course, crises can lead to bad as well as to good social change.

Nevertheless, the historical record should give some hope and direction to tax reformers.

NOTES

1. When multiple overlapping jurisdictions tax the same base, it leads to a different sort of tragedy, a tragedy of the anticommons. For more details, see Mitchell and Stratmann (2015).
2. This chapter offers a short preview of a book I am currently writing on the subject of overcoming special interests.
3. For the costs of federal tax complexity from a market-oriented perspective, see Fichtner and Feldman (2013). For the costs of state tax complexity from a progressive perspective, see Weinstein (2014).
4. Married homeowners with children, for example, are privileged (Harris and Parker 2014).
5. As the economists Leonard Burman and Joel Slemrod (2013, 72) put it, "only a small fraction of the cost of a factory that will last twenty years is really a cost of earning income this year."
6. See chap. 3 of their book. Note that this, along with other aspects of their proposal, make it a flat consumption tax.
7. My own view is that Hall and Rabushka have it right. See Mitchell (2013).
8. According to one model, the effect on income inequality would be "exceedingly modest." Gale et al. (2015).
9. For a broader overview of policies that privilege particular interest groups, see Mitchell (2012).
10. These include the mortgage interest deduction, the exclusion of principal residences from capital gains taxation, the tax free status of imputed rental income from owner-occupied residences, and various rules that keep state property taxes low. For details, see Hasen (2015). To be more precise, many of these provisions attend "home borrowship" rather than ownership (Kling 2008).
11. Gale et al. (2007, 1171): "Evidence suggests, however, that the mortgage interest deduction . . . does little if anything to encourage homeownership. Instead, it serves mainly to raise the price of housing and land and to encourage people who do buy homes to borrow more and to buy larger homes than they otherwise would." Glaeser and Shapiro (2003, 39): "While the deduction appears to increase the amount spent on housing, it also appears

to have almost no effect on the homeownership rate." Mann (2000, 1391): "None of the evidence from economists or from other countries suggests that the repeal of the home mortgage interest deduction would reduce demand for owner occupied housing or home ownership rates."

12. The concept was first developed by Tullock (1967), though the term was coined by Krueger (1974).
13. For an overview of the literature, see Congleton et al. (2008).
14. Olson identified other ways that groups might overcome their collective action problems. For example, a group might offer selective benefits to those who contribute to their collective goals.
15. Drutman's findings are particularly depressing when one considers the fact that formal models of rent-seeking contests demonstrate that rent-seeking losses are greatest when no barriers to rent-seeking exist and when there are economies of scale in rent-seeking. For more, see Mitchell (2015).
16. Though it appears to refer to the practice of rolling logs, the term's origins are unclear.
17. "Lobbyists' Delight," *Economist*, October 14, 2004, http://www.economist.com/node/3291288.
18. Agenda manipulation can also occur in single-issue space if some portion of the electorate has what are known as "multi-peaked preferences." The proofs are somewhat technical. For an overview, I refer the curious reader to Mueller (2003, 84–103).
19. Quoted in Tullock (1975, 671).
20. Charles Warren (1926, 616). The "Dormant Commerce Clause" doctrine took some time to materialize. But it is generally considered to have begun with Gibbons v. Ogden, 22 U.S. (Wheat.) 1 (1824).
21. Dick Armey, author's interview with Representative Dick Armey, March 15, 2013.
22. "US Loses to China in WTO Trade Dispute," *DW.COM*, July 14, 2014, http://www.dw.com/en/us-loses-to-china-in-wto-trade-dispute/a-17785657.
23. The prisoners' dilemma is perhaps the most celebrated game in game theory. Originally developed by Merrill Flood and Melvin Dresher, Albert Tucker formalized it in 1950 and used the example of prisoners to illustrate it (Tucker 1983). Models of special interest politics often take this form. See, for example, Tullock (1959) and Buchanan and Tullock (1962).
24. "The POLITICO 50: 2015—Timothy P. Carney, Veronique de Rugy—Washington Examiner Columnist; Mercatus Center Researcher," *POLITICO Magazine*, 2015, http://www.politico.com/magazine/politico50/2015/timothy-p-carney-veronique-de-rugy.
25. As of this writing, the bank's fate is uncertain. After bank boosters employed a rare procedural maneuver to bring reauthorization up on the House floor, it was reauthorized. Since its board lacks a quorum, however, the bank cannot make large loans.
26. *Rahm Emanuel: You Never Want a Serious Crisis to Go to Waste*, 2009, https://www.youtube.com/watch?v=1yeA_kHHLow.
27. Lincoln's own commitment to the cause was clearly shaped by external forces. His famous Emancipation Proclamation was only issued after the Union had won at Antietam and at any rate only freed those slaves held in the Confederacy.
28. Lord Acton warned: "At all times sincere friends of freedom have been rare, and its triumphs have been due to minorities, that have prevailed by associating themselves with auxiliaries whose objects often differed from their own; and this association, which is always dangerous, has been sometimes disastrous, by giving to opponents just grounds of opposition, and by kindling dispute over the spoils in the hour of success" (Dalberg-Acton 1907, n.p.).

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