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CONCLUSION

Moving Forward: Tax Policy Lessons

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On July 17, 2014, a plainclothes New York Police Department officer approached a man he believed to be selling untaxed cigarettes in Staten Island. The suspect was unarmed. An hour later, the suspect was pronounced dead at the Richmond University Medical Center.

The rash actions of the New York City Police Department that resulted in the tragic death of Eric Garner were initiated because he was suspected of tax evasion. Excessive cigarette taxation created the environment that ultimately led to Mr. Garner's death. Selective taxation imposes real costs on individuals in our society, and these costs extend far beyond the superficial discussion of dollars paid.

To say that selective taxes are the primary source of society's social and economic problems would certainly be an overstatement, but selective taxes do have real costs. Every day millions of Americans, predominantly from lower-income households, are made worse off because of selective taxes. Life is made unnecessarily more difficult as the government increases prices, makes arrests, and paternalistically makes choices for people who should be free to choose on their own.

Creating effective public policy is difficult. The myriad unintended and secondary consequences of tax and expenditure policy create much confusion regarding both the source of and solutions to social problems. Further adding to the complexity of effective policy making is the fact that policy is enacted through a political process that tends to reinforce discriminatory and inefficient policy solutions. The political system is plagued by imperfect information and unchecked self-interest.

The analytical approach of this book has been to apply fundamental economics to evaluate selective sales and excise tax policy. We examined the expected behavior of self-interested political participants under various institutional rules, incorporating lessons from public choice theory, constitutional economics, law and economics, and behavioral economics, among other fields of study.

In this final chapter of the book, we summarize the common themes gleaned from the contributed chapters. We then conclude the book with a discussion of policy recommendations. We suggest policies that make taxes less burdensome, more efficient, and more transparent.

RESEARCH FINDINGS

The broad conclusions deduced from the earlier chapters suggest that the democratic system is rife with rent-seeking. Without proper restrictions on the actions of policymakers, the system inevitably results in a churning of discriminatory policy.

Tax policy can and should be improved, and the lessons of this book can aid in this process. While each contributed chapter can stand alone in advancing the discussion of improved tax policy, we summarize the common findings in each section of the book.

Part I. Public Finance and Public Choice: Establishing the Foundation

Selective sales and excise taxes do not enhance efficiency. Instead, selective taxation predictably and discriminately benefits elite politically favored groups at the expense of other politically disfavored and disenfranchised groups.

Discriminatory tax policy catering to the special interests of politically favored individuals, firms, and industries is a common concern raised throughout this book. Current tax policy is the result of a long series of small discriminatory modifications to the status quo. Each modification represents

the outcome of the influence of special interests who gain political support for tax changes that disadvantage competitors or impose costs on others to fund a concentrated expenditure benefiting the special interest. Each modification to the existing broad tax structure comes at an increasing marginal cost as discriminatory provisions become more and more prevalent, until large-scale tax reform becomes feasible. The sequence of new discriminatory modifications is then restarted until the next large-scale reform is possible.

Part II. The Political Economy of Public Budgeting

Policymakers lie, deceive, and act on incomplete information when creating tax policy. The chapters in this section point out that tax policy can be exceedingly complex. Policy is manipulated to conceal the goal of feeding ever-expanding budgets rather than pursuing the social well-being. Selective taxation is also enacted using strategies that make it difficult for voters to identify and assess the impact of a tax.

Even when policy seems well intentioned and straightforward, such as a lottery tax earmarked to be spent on education, the observed outcomes are complicated and often not what was promised. Tax earmarking is a convenient approach to gain support for tax increases, but it rarely leads to anything resembling the promised increased expenditures in the targeted area. Taxation also leads to a large number of secondary effects that often cause substantial burdens on those most vulnerable in society.

Part III. Fiscal Federalism and Selective Taxation

Under the appropriate institutional rules, intergovernmental competition that exists under fiscal federalism can encourage efficient and equitable tax policy. Unfortunately, it is clear that the existing institutional rules governing state and local tax policy need much improvement to result in the oft-promised economic growth, long-term stability, and overall improved well-being.

State and local government attempts to drive economic growth by selective subsidies have failed to deliver time and time again. Not only have these saint subsidies not led to economic and job growth, but they also necessitate increased taxation, often in the form of selective taxes. However, selective taxes fail to fund large-scale expenditures, such as infrastructure and pensions, and the burden of such taxes generally falls heavily on less-wealthy local residents. Institutional changes are necessary to encourage improved state and local tax policy.

Part IV. The Economics of the Failing Nanny State

As a coercive tool, selective sales and excise taxes fail to improve individual and societal well-being. Whether the goal is to discourage the use of plastic shopping bags, unhealthy eating habits, cigarette smoking, or other undesirable behavior, hard nudges simply fail to improve well-being as promised. In many cases the taxes are counterproductive, leading to worsening health and environmental conditions.

The effects of prohibitive taxation—or, as coined by Michael LaFaive, “prohibition by price”—share more in common with the failures of alcohol and narcotics prohibition than with effective tax policy. While taxation does lead some consumers to avoid the consumption of the good, many others turn to the underground economy for less expensive options. This brings along with it greater exposure to a whole host of undesirable outcomes for the individual, including violence to person and property, a distrust between law enforcement and all citizens, and severe legal repercussions that can also limit future employment prospects.

There are better alternatives than selective taxation to help empower consumers make more informed and better choices.

Part V. Evaluating and Prescribing Better Tax Policy

The tax code reflects the preferences of special interests and paternalistic politicians. Because those preferences vary, we observe different policies across the country. The difference in policies provides an opportunity to study the effects of these discriminatory taxes and from such studies; we can formulate recommendations for better policy.

PRESCRIBING BETTER POLICY

We consider various policy alternatives to the existing system of selective and discriminatory taxation. Our policy recommendations range from the ideal to those serving only to modestly improve the status quo. We recognize the first-best policy prescription is not always politically feasible. It is far better to take even small steps toward improved policy than to simply accept the inadequacies of the status quo.

The following list of policy guidelines should not be viewed as either-or. Instead, policymakers can improve their tax codes by incorporating any number of these prescriptions.

First-Best Policy

1. Eliminate selective taxes. Selective taxes are poor policy tools. Get rid of them. Allow individuals to make their own choices.

If the heavy hand of paternalism cannot be completely removed and government wants to continue to play a role in individual choices, we offer second-best policy recommendations for behavioral programs. If the government simply cannot function without the revenue currently provided by selective taxation, we also provide second-best policy recommendations for revenue generation.

2. Constitutionally limit government's power to tax discriminatorily. As Richard Wagner notes in chapter 4, constitutionally limiting a government's ability to discriminate among taxpayers reduces that government's ability to affect the commercial value of individual enterprises. This, in turn, reduces the return on—and therefore the value of—campaign contributions and engaging in other forms of rent-seeking. The precise language or content of such a constitutional limit is still debated. As has been observed in the debate over the proper balanced budget amendment,¹ walking the line between too little and too much specificity is challenging. This is no easy task.

For example, an effective constraint would need to be specific enough to eliminate the subjective determination of what can be labeled as discriminatory, yet broad enough so as to capture future political innovations in policy-making designed to skirt the constraint. Furthermore, such an amendment limiting politicians' abilities to engage in discriminatory taxation (and expenditure) would certainly face heavy opposition from the very enterprises currently benefiting from the status quo. It is very likely that, as has been the case in many states passing restrictions on eminent domain usage for private gain (Lopez et al. 2009), pressure will mount for the passage of a constraint that is more symbolic than truly effective. Ultimately, the proper content of such a constitutional constraint is likely something that is best discovered through various state-led attempts at restricting discriminatory policy making.

3. Make taxation more transparent by collecting all taxes from consumers and workers.

Lack of transparency is a huge political advantage. And basically, call it the stupidity of the American voter or whatever, but basically that was really really critical for the [Affordable Care Act] to pass. And it's the second-best

argument. Look, I wish Mark was right that we could make it all transparent, but I'd rather have this law than not. (Jonathan Gruber, MIT economist and co-designer of the Affordable Care Act)²

Can tax policy be more deplorable? Taxes are too often designed to be disguised, hidden from the would-be taxpayer. Gruber's argument in the quote above succinctly states that if the American voters, Congress members responsible for voting on the Affordable Care Act (ACA), and the Congressional Budget Office responsible for summarizing the economic impacts of the ACA accurately understood what the bill would do, the bill would have been voted down. The implicit argument here is that the architects of the bill clearly knew what was better for the American people than any of the other parties responsible for making that decision and any of the people that would be affected by the bill.

We borrowed the above quote from Randall Holcombe's chapter 5. Holcombe goes on to describe the way in which many taxes are hidden from taxpayers. The most popular means of disguising a tax is to apply the tax to producers.

Those absent the knowledge of Economics 101 may believe that the tax incidence of supply-side tax falls on businesses or producers. That is simply not the case. Taxes are almost always passed along to consumers in the form of higher prices.

How, then, to make taxes more transparent? Simplifying the tax code by eliminating selective taxes would be a great start. Short of that, we recommend collecting *all* taxes from consumers and workers. Sales, excise, use, and selective taxes are almost exclusively collected by producers. Employers withhold employee federal income tax, state and local income tax, Medicare tax, Social Security tax, unemployment insurance tax, and disability insurance tax. Basic economics tells us that market prices and quantities will not be affected by which party—consumer or producers; employers or employees—has to hand the tax money over to the government.

A common argument in favor of producers/employers collecting taxes is convenience. However, when convenience results in a lack of transparency and a misunderstanding of the cost of government, convenience becomes a weak argument. Voters should face head-on the cost of the government we collectively consume, just as we each face the cost of consuming private goods. Costs of consumption should be transparent; only then can we make more informed choices in the voting booth.

Second-Best Guidelines

4. Minimize selective taxation—both in scale and scope. Decrease or remove the tax rate on existing selectively taxed goods. Create no new selective taxes.

If completely removing the tax rate on traditionally taxed goods (e.g., cigarettes, alcohol, gasoline, and gambling) is too unpalatable, decreasing the tax rate is a step in the right direction. A gradual phase out may be easier for budget adjustments. However, an immediate, complete elimination of a particular tax may be more politically feasible for areas in which political power oscillates.

We recommend similar policy for the scope of selective taxation. As we mentioned in the introduction, discriminatory taxes have expanded far beyond the scope of cigarettes, alcohol, gasoline, and gambling. In various parts of the country, extra taxes are applied to playing cards, fur clothing, marijuana, sex-related or nude services, candy, soda, chewing gum, potato chips, pretzels, milkshakes, baked goods, ice cream, popsicles, bagel slicing, sporting or entertainment tickets, parking, hotel rooms, medical devices, electric cars, health insurance, *not* purchasing health insurance, and many other goods. Scale back the scope of these taxes and stop the growth of selective taxes on new items.

5. Use more broadly based taxation. For government revenue needs, use broadly based taxes, such as the general sales tax and the income tax. These taxes are more transparent and raise revenue more effectively than do selective taxes.

On a cautionary note, exemptions from broadly based taxes often mirror the effect of distortionary selective taxes. The federal income tax code has been modified over time to selectively encourage the purchase of hybrid vehicles, energy-saving replacement windows, and roofing while also incentivizing the production of ethanol, among many other items.

Likewise, the general sales tax is anything but “general” these days. The list of items exempted from sales taxation in any given state is striking. For instance, the Ohio Department of Taxation provides a sixty-two point list of types of sales that are exempted from sales tax.³ The list of exempted sales in Ohio has shrunk in recent years. The *Cleveland Plain Dealer* reported that 127 items were exempt from the general sales tax in 2013.⁴ Some of the items for which the exemption was removed in the 2013 biannual budget include “bank service charges; overnight trailer parks; bowling alleys and billiard parlors; hunting and fishing guides; pari-mutuel racing events; and admission to museums, amusement parks, circuses, fairs, concerts and sporting events that

don't involve an educational institution."⁵ The elimination of some sales tax exemptions coincided with a modest sales tax rate reduction.

The State of Ohio's combination of broadening the base while reducing the rate is a step in the right direction for reducing the state's discriminatory influence on market outcomes, although Ohio could go further. Other states are encouraged to follow suit by also broadening the general sales tax base (eliminating exemptions) and lowering the sales tax rate to maintain revenue neutrality. A similar approach could be used in the taxation of income at all levels of government.

6. Limit new expenditure programs and expansions of existing ones. Public programs (e.g., Medicaid and Medicare) as well as new laws (e.g., the ACA) have helped create an environment in which taxpayers believe they should have the right to control how other citizens live and what they consume. The consumption of cigarettes, trans fats, and sugary drinks (among many other items) certainly can lead to various health concerns for the individual consumer, particularly if not consumed in moderation. These are cases of what Adam Hoffer and William Shughart in chapter 3 describe as "internalities," in which consumption choices can harm one's future self. The consumption of too much salt or sugar imposes a personal cost on the individual consumer; it does not naturally produce an externality problem.

However, establishing programs to force taxpayers to pay for medical expenses and enacting tax policy that favors employer-provided group insurance plans does create an environment in which less healthy consumption choices impose greater costs—higher taxes or higher insurance premiums—on others. The end result is an environment in which taxpayers and group insurance plan participants believe they should have a say in the consumption decisions of other individuals. A common policy response is to impose discriminatory excise taxes on politically incorrect consumption. As Randall Holcombe mentions in chapter 5, these taxes fall on a minority of the population, who are argued to be deserving of taxation due to their behavior.

To be clear, the external costs in the form of higher taxes and group insurance premiums is a policy failure rather than some form of market failure. There would be no policy-relevant external costs to speak of in the absence of public funding for health care. In order to reduce voter support for increased discriminatory selective sales and excise taxes to be used as hard nudges, governments would be best to roll back public provision for health care. At the very least, governments should restrict further expansion of existing programs and not support the passage of new expenditure programs.

7. Use more carrots, fewer sticks. Selective taxes are often used as a measure to discourage consumption. Policymakers and industry professionals want to steer consumers toward “better” choices. Smoking is detrimental to an individual’s health. Increasing the price will decrease overall cigarette consumption, of course. But most people do not quit, and those who continue to consume shoulder an even heavier financial burden. Plus, as Michael LaFaive detailed in chapter 15, prohibition by price carries tremendous unintended consequences, such as the development of underground markets.

If the goal of public policy truly is to help people, use more carrots and fewer sticks. Reward healthier, more pro-social behavior. Stop punishing individuals with heavy-handed taxation or, in the case of the war on drugs (see Bruce Benson and Brian Meehan’s discussion in chapter 8), jail time for their behavior. Economic and psychology research shows again and again that rewards are equal to or better than punishments at influencing behavior. And rewards come with fewer unintended consequences.

If politicians want less smoking, help people quit who want to quit. Use information and support groups to help people quit cold turkey. The Australian government subsidizes nicotine patches, for example.⁶

Worried about too much sugar or fat consumption? Help people purchase fresher, healthier options. Support farmer’s markets in urban food deserts. Reward via a tax break or medical subsidy individuals who lose weight.

Rewards are a powerful tool for behavioral change. Public policy should be designed to help people, not to inflict varying degrees of punishment.

8. Localize policymaking where possible. In chapter 13, J. R. Clark and Dwight Lee present an intriguing and innovative approach to the federal tax code. The focus of their proposal is to rely on the competitive pressures present in fiscal federalism to encourage better tax and expenditure policy. What is unique in their proposal is the high effective cost of enacting expenditure programs that benefit special interests. Such a tax structure discourages special interest legislation, including subsidies to encourage firm relocation (see Peter Calcagno and Frank Hefner’s chapter 10) and sports subsidies (see Dennis Coates and Craig A. Depken II’s chapter 11), areas in which there is substantial competition across cities and states. Overall, Clark and Lee’s tax reform proposal discourages wasteful spending while encouraging low and efficient taxation methods.

Despite the potential good that can stem from Clark and Lee’s tax reform proposal, such an extreme tax change is unlikely anytime soon. However, the basic idea to encourage a good competitive environment across government units can be applied in other ways. For example, the reduction or elimination

of many intergovernmental grants could encourage better tax and expenditure policy. Some of the intergovernmental grant programs are, at least in part, supported by efficiency arguments. For instance, according to Edward Gramlich (1990, 1994), the spillover benefits to nondirect users of interstate highways in California—that is, those of us who do not drive on California highways—justify a federal subsidy to cover 30 percent of the expenditure on highway infrastructure. A similar approach could be used for other expenditure areas, such as education, health care, public housing, and welfare spending. If Gramlich's approach is applied to all intergovernmental grant programs, federal expenditures on such grants is expected to fall substantially, leaving states with increased responsibility to pay for programs that benefit their own constituents and greater incentives to enact only those programs that pass a benefit-cost analysis.

Creating an environment in which inefficient state and local policies are no longer paid for largely by far-away taxpayers, who have little knowledge of the decisions being made and no responsibility for electing those who make the decisions, will put greater pressure on elected officials to support cost-effective policy and keep taxes lower. Barry Weignast, Kenneth Shepsle, and Christopher Johnsen's (1981) model, now commonly referenced as the "Law of $1/N$," explains how tax exporting through intergovernmental grants encourages the passage of inefficient policy, potentially greatly increasing the tax liability across all jurisdictions. Restricting the ability of state and local governments to rely on intergovernmental grants would cause both voters and elected officials to be more concerned with the net benefits of proposed expenditures, as those in the jurisdiction would face the full cost of the expenditure rather than just a small percentage of it.

As a second example, the desire to enact numerous selective sales and excise taxes to fund subsidies for professional sports stadiums and other large businesses could be limited by an appropriately constructed federal policy. In fact, former President Obama supported a policy along these lines in his budget proposal in 2015. The then president sought to prohibit the use of tax-exempt bonds to finance professional sports stadiums (Povich 2015), an act that would not prohibit sports subsidies but one that would arguably limit the ability of franchise owners to pit city against city in an effort to extract large subsidies funded by taxpayers.

The goal here is to rely on the benefits of a localized system of government. Local elected officials have a knowledge advantage concerning the needs of their constituents more so than politicians elected for federal office. Local officials may also face greater incentives to act in the interest of their

constituents as they are more likely to answer questions when venturing out to the local coffee shop or grocery store. Underperforming local governments may suffer from poor policy choices as residents and businesses are mobile. Without restrictions on intergovernmental grants, which disconnect the funding from those who benefit, and on selectively issued subsidies to attract businesses, local governments may engage in inefficient competition and wasteful expenditures. By reducing wasteful expenditures, the call to employ discriminatory selective sales and excise taxation will also be reduced.

CONCLUSION

Public policy is complex. Outcomes are difficult to measure and the best policies can be politically unpalatable. To the extent economists have identified the effects of selective taxes, the taxes fail to improve the lives of citizens. The combination of misaligned incentives and paternalistic tendencies of policymakers make selective taxes a poor choice for public policy intended to improve well-being. Selective taxation should be eliminated where feasible and otherwise transparent and highly limited by constitutional constraints. In circumstances where the first-best policies cannot currently be implemented, we offer policies that are a step in the right direction, including a focus on broader taxation, more carrots and fewer sticks, and limiting unsustainable government expenditures. By adhering to these guidelines, elected officials will help promote a less discriminatory tax code that also contributes to an institutional environment supportive of a more prosperous society.

NOTES

1. See, for example, McCulloch (2012).
2. The Gruber quote can be found at www.forbes.com/sites/theabothecary/2014/11/10/aca-architect-the-stupidity-of-the-american-voter-led-us-to-hide-obamacares-tax-hikes-and-subsidies-from-the-public/#d008d52779b.
3. See <http://www.tax.ohio.gov/faq/tabid/6315/Default.aspx?QuestionID=433&AFMID=11354>, accessed May 16, 2017.
4. "The Taxes You Don't Pay: All 127 Exemptions from Ohio State Taxes," *Cleveland Plain Dealer*, February 4, 2013, http://www.cleveland.com/metro/index.ssf/2013/02/the_taxes_you_dont_pay_all_127.html.
5. "State's List of New Things to Tax Is Long," *Columbus Dispatch*, February 7, 2013, <http://www.dispatch.com/content/stories/local/2013/02/07/states-list-of-new-things-to-tax-is-long.html>.
6. See http://www.pbs.gov.au/info/publication/factsheets/shared/Extension_of_the_listing_of_nicotine_patches.

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