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Some Tax Advice for Latvia and Other Similarly Situated Emerging Economies

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Some Tax Advice for Latvia and Other Similarly Situated Emerging Economies

Robert W. McGee†

The design of an effective tax structure is one of the most difficult tasks and controversial problems faced by an emerging economy. Latvia faces not only the basic policy choices confronted by all nations in structuring tax policy, but also special problems connected with its transition to a market economy. This article outlines some of the key perils that Latvia and other emerging economies may face, and proposes means of avoiding many of those problems.

The article begins with a discussion of the attributes of a good system of public finance in any country and the means of implementing such a system. The article then considers the problems which Western economies have encountered in the formation and operation of their own tax systems, and identifies perils that nations in Latvia's position would do well to avoid. Following its analysis of the Western experience, the article focuses on the special problems that newly emerging economies may encounter, as well as the approach currently in operation in Latvia itself. Finally, the article presents guidelines for the construction of a tax system in Latvia and other emerging economies.

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I.

INTRODUCTION

The scope of this paper encompasses the tax systems and problems of *every* emerging market economy.¹ Although the author discusses the tax system of Latvia in particular, Latvia's tax situation is not unique. Many of the problems and policies that now exist in Latvia also exist in most other emerging market economies. The Latvian case is used only as an example for illustrative purposes.

Latvia, like many other countries that are emerging from a centrally planned economic system to a market system, is in the process of establishing a tax system that will serve its future needs. During this transformation, it is likely to encounter a number of problems. Some such problems will be similar to those encountered whenever any government attempts to establish a tax policy. However, some problems will be unique to emerging economies. This paper examines both types of problems and makes recommendations for easing this process based on the experiences of the Western democracies.

The present study is not limited to a discussion and analysis of purely economic (utilitarian) approaches, but extends to issues involving political philosophy. Tax systems that are based on mere efficiency—collecting the most tax at the least economic cost—ignore many relevant issues. Yet nearly all economic studies either completely ignore noneconomic issues or give them cursory examination and discussion. The present study begins by establishing a philosophical base upon which a tax system can be built, then expands the discussion to examine the ways in which such a system can be structured.

Part II outlines the attributes of a good system of public finance. Part III presents an overview of the income tax system in the United States. Part IV discusses the value added tax, which is used by most countries in Western Europe as a means of raising revenue. Part V discusses and analyzes the pros and cons of alternative means of generating revenue. Part VI addresses the special problems of raising revenue in an emerging economy. Part VII provides an overview of the tax system in Latvia, and offers a commentary on its present tax rules. Lastly, Part VIII outlines possible guidelines for Latvian and other policy-makers engaged in structuring their respective tax systems.

1. Examples include any Eastern or Central European economy that was in the Soviet bloc, as well as many countries in Asia, Africa and Latin America. Some countries in the Middle East could also benefit by adopting the suggestions made in this paper.

II.

ATTRIBUTES OF A GOOD SYSTEM OF PUBLIC FINANCE

A. Introduction

Before we can discuss what constitutes a good system of public finance, a few words must be said about what constitutes a good system of government. There is a diversity of opinion on this point, and the basic vision of government with which one begins affects the kind of public finance system one constructs. This author begins with the premise that the best government is one that governs least,² a position consistent with the view that the private sector can do just about anything more efficiently than the government.³ Ample evidence supports this idea.

Efficiency is only one aspect. An even more important aspect to consider is whether the government should limit itself to the protection of life, liberty and property—a nightwatchman state—or whether it should be active in the redistribution of income as well. According to the “nightwatchman state” theory, the public finance system will be aimed merely at raising revenue for the support of essential government functions. Conversely, under a more expansive view of government, the public finance system will also be used to aid in the redistribution of income and as a tool of macroeconomic policy.

Several aspects of the more expansive view are suspect. First, it is questionable whether tax policy should be used as a tool for macroeconomic policy. One author, taking an extreme Keynesian position, says that “[t]axes are needed not to provide governments with money but to take money away from the public.”⁴ In other words, taxes exist to increase or reduce public spending and to cool an overheated economy or rev up an economy during recessions. Aside from the fact that developing countries do not suffer from overheated economies, the Keynesian premise that tax policy can function as an effective macroeconomic policy tool has been refuted for decades.⁵ Yet the theory continues to influence public finance theorists and practitioners.

2. For treatises that take this view, see F.A. HAYEK, *THE CONSTITUTION OF LIBERTY* (1960); F.A. HAYEK, *LAW, LEGISLATION AND LIBERTY*, three vols. (1973, 1976, 1979); ROBERT NOZICK, *ANARCHY, STATE AND UTOPIA* (1974).

3. See, e.g., *PRIVATIZATION* (John C. Goodman ed., 1985); RANDALL FITZGERALD, *WHEN GOVERNMENT GOES PRIVATE: SUCCESSFUL ALTERNATIVES TO PUBLIC SERVICES* (1988); JAMES T. BENNETT & MANUEL H. JOHNSON, *BETTER GOVERNMENT AT HALF THE PRICE* (1981); ROBERT W. POOLE, JR., *CUTTING BACK CITY HALL* (1980); E.S. SAVAS, *PRIVATIZING THE PUBLIC SECTOR; HOW TO SHRINK GOVERNMENT* (1982); MADSEN PIRIE, *PRIVATIZATION: THEORY, PRACTICE AND CHOICE* (1988); OLIVER LETWIN, *PRIVATIZING THE WORLD* (1988); *PRIVATIZATION & DEVELOPMENT* (Steve H. Hanke ed., 1987).

4. RICHARD M. BIRD, *TAX POLICY & ECONOMIC DEVELOPMENT* 4 (1992).

5. Space does not permit a full discussion of this point. Basically, the refutation of the Keynesian position can be summarized as follows: The Keynesian position advocates increasing taxes during the boom phase of the business cycle and reducing taxes during the recession phase. The problem is that it takes time for the legislature to change the tax law and additional time for the tax cut or tax increase to take effect. By the time the law is changed and the tax change takes effect, the economy is in a different phase of the business cycle. A tax cut, for example, might start to take effect when the economy is in the boom phase, which would heighten the boom. A tax increase

Another questionable role of tax policy is its use as a means for altering consumption and production patterns. The basic question to be asked is: "Who should determine how much individuals spend and how much they consume, the consumers themselves or government bureaucrats?" While economies that save more and spend less might have a higher growth rate, that fact alone does not justify government attempts, through tax policy or by any other means, to affect consumer spending decisions. If the role of government is that of servant rather than master, then such a role is not a legitimate function of government. Servants do not use coercion to alter their masters' spending patterns and neither should governments. Individuals should be able to make their own spending and saving decisions if the role of government is strictly limited to the defense of life, liberty and property.

The third questionable role of tax policy is as a means for the redistribution of income. If the proper role of government is to protect property rights, then it violates this basic role when it engages in the redistribution of income since, in order to perform this function, it must take money from those who have earned it and give it to those who have not. Thus, government undermines property rights rather than protecting them when it engages in redistribution of income.⁶

One might argue that due to market failures, some amount of redistribution is called for to remedy social injustice. This theory, however, suffers from several problems.⁷ First, the definition of "market failure" is not at all clear. The market, when unhampered, generally tends to provide the goods and services that people want. If someone wants something but is not willing to pay the market price, it is not market failure; it is simply lack of effective demand. If the government steps in to provide the product or service, it might have to shift resources from more productive uses to less productive ones to satisfy this "need" that is not supplied by the market, thus reducing total utility rather than enhancing it.⁸ Another problem with the theory of market failure is the view

might take effect during the recessionary phase, thus deepening the recession. Another criticism of the Keynesian approach is that the money taken by a tax increase is not only taken out of the pockets of consumers, but also put into the hands of government. The government spends the funds that consumers cannot spend, so total spending is not reduced, but merely shifted from the private sector to the public sector, with the result that resources are merely shifted (presumably to a less efficient use) rather than reduced. For refutations of the Keynesian position, see W. H. HUTT, *KEYNESIANISM: RETROSPECT AND PROSPECT* (1963); W. H. HUTT, *THE KEYNESIAN EPISODE: A REASSESSMENT* (1979); HENRY HAZLITT, *THE FAILURE OF THE "NEW ECONOMICS"* (1959); *THE CRITICS OF KEYNESIAN ECONOMICS* (Henry Hazlitt ed., 1960); *DISSENT ON KEYNES: A CRITICAL REAPPRAISAL OF KEYNESIAN ECONOMICS* (Mark Skousen ed., 1992) [hereinafter *DISSENT ON KEYNES*].

6. It might be argued that the redistributive state involves unethical conduct. For a treatise on this point, see BERTRAND DE JOUVENEL, *THE ETHICS OF REDISTRIBUTION* (1952 & 1989).

7. For discussions of the weakness of the theory of market failure, see *THE THEORY OF MARKET FAILURE: A CRITICAL EXAMINATION* (Tyler Cowen ed., 1988); MARK SKOUSEN, *ECONOMICS ON TRIAL* 145-57 (1991); James M. Buchanan, *Market Failure and Political Failure*, 8 *CATO J.* 1 (1988); HANS-HERMANN HOPPE, *THE ECONOMICS AND ETHICS OF PRIVATE PROPERTY* 13-14, 124 (1993); MURRAY N. ROTHBARD, *MAN, ECONOMY AND STATE* 887 (1962).

8. For an exposition of the view that government intervention always reduces total utility, see ROTHBARD, *supra* note 7, at 768-73.

that government intervention can make things better. Sometimes government intervention is worse than market failure.

A third problem with the theory of market failure involves the concept of what constitutes justice or fairness. Those who advocate government intervention as a cure for injustice view justice as a destination rather than a process. Where there are individuals with low income, an interventionist would advocate taxing the rich and distributing the proceeds to the poor. However, justice should not be viewed in this manner. Taking property from some and giving it to others is unjust to those who must surrender their property. One cannot enhance justice by violating people's rights. When determining whether something is just, we must not ask how things are, but how things got that way. In other words, justice must be viewed as a process, not a destination. If the present situation is the result of voluntary exchange, the situation is just. If the present situation is the result of the violation of property or other human rights, the situation is unjust.⁹

But, you might argue, if government didn't do all that it's doing, we wouldn't have a *just* society. What is *just* has been debated for centuries, but let me offer my definition of social justice: I keep what I earn and you keep what you earn. Do you disagree? Well then, tell me how much of what I earn *belongs* to you—and why?¹⁰

This author takes the position that the nightwatchman model of government should be preferred to other forms because the nightwatchman model is the only form that does not exploit some citizens for the benefit of others. A free society should not be based on coercion. The only legitimate functions of government are to protect basic natural rights, negatively defined, such as the rights to life, liberty and property. Space does not permit a full discussion of this point, but others have already discussed it in depth.¹¹

All systems of public finance contain certain attributes. Some attributes conflict with other attributes, and some approaches are better than others. There

9. Walter Williams makes this point in *ALL IT TAKES IS GUTS* 81 (1987). It is made in many other places as well, including Nozick, *supra* note 2. Nozick's book points out some of the weaknesses of the position espoused by John Rawls in *A THEORY OF JUSTICE* (1971). Rawls takes the position that rights can sometimes be violated if the goal is to redistribute income; in other words, the end can sometimes justify the means.

10. WILLIAMS, *supra* note 9, at 62.

11. One of the better discussions may be found in Nozick, *supra* note 2. See also FREDERIC BASTIAT, *THE LAW* (1968). Natural rights are rights that exist before the institution of government. Governments are instituted to protect such rights. These rights include the rights to life, liberty and property. Stated negatively, these rights would be the right not to be killed, the right not to be involuntarily confined, and the right not to have your property taken from you without your consent. In contrast to these negative rights are positive rights, such as the right to education, the right to health care, the right to low rent, and so forth. These rights are not inherent but come from government. Another distinguishing feature is that in order for one individual or group of individuals to have a positive right, someone else's negative rights must be violated. For example, if someone has a right to health care, someone else must be forced to pay for it through the tax system (a violation of property rights). If someone is entitled to a "free" education, then someone else must be forced to pay for it. In a positive rights regime, one person gains at the expense of another. In a negative rights regime, no one gains at the expense of another. The nightwatchman state limits itself to the protection of negative rights.

is even some debate as to what constitutes “better.” There is certainly more than one way to evaluate “better” and “worse.” From a strictly *wertfrei* (value free) economic approach, a better approach is one that gets you from point A to point B the fastest and/or at the least cost.

An extreme example of this value free approach would be to ask whether it is better to kill people by stabbing them or shooting them. The answer to this question can be determined merely by comparing the relative efficiency of both options. No moral judgments come into play. Value judgments become involved only if one asks whether one should try to get from point A to point B, or whether one should kill people.

As can be seen from the above example, ignoring moral value judgments is a major defect of the utilitarian approach to resolving complex problems. This paper, therefore, will attempt to go beyond a merely utilitarian approach in its evaluation of public finance principles.

This part of the paper will discuss and evaluate some of the attributes and alternative approaches that are present and available in any system of public finance. In determining whether a particular approach is good or bad, both the value free and value laden approaches will be used at various times. From a strictly value free perspective, an approach will be considered good if it is the most efficient. From a value laden or moral perspective, the guidepost is whether it relies on coercion. Policies that can be implemented without coercion, or attributes that do not depend on coercion or the disparagement of property rights should be preferred to alternatives that require coercion or the disparagement of property rights. In cases where the economic solution is in conflict with the moral solution, the moral solution should prevail. Morality should be preferred to efficiency. Thus, this paper goes beyond pure economics because pure economics restricts itself to the study of the efficient allocation of resources without the consideration of moral value judgments.

Public finance attributes can be subdivided into several categories. There is no need to point out that any attempt to classify or categorize attributes of a good public finance system involves some arbitrary decision making on the part of the writer. Such attributes can have both economic and noneconomic aspects. This paper begins with the examination of issues that are primarily philosophical in nature. Issues that are primarily economic in nature are examined next.

B. Philosophical Issues

1. The Theory of Voluntary Taxation

Governments can raise revenue through coercion or through voluntary exchange. Income, property, estate and gift taxes are examples of coercive forms of taxation because those paying have no choice—they must pay or face the possibility of punishment. Voluntary forms of revenue raising include lotteries and user fees.

One may argue that taxation is not really coercive because voters have consented to be taxed. However, there are a number of flaws in this reasoning. For one thing, the voters who consented to be taxed did so long ago. In the case of the individual income tax in the United States, for example, they gave their consent in 1913.¹² Many of the people who consented at that time are now dead. And many of those who voted then did not give their consent. It is a fundamental principle of both common law and basic justice that one person cannot be held for the contract of another. Thus, even if consenting to be taxed is viewed as a contract between citizens and the state, the contract is void as far as those who did not consent are concerned. Taxation is not noncoercive just because some group of voters in the past agreed to be taxed.

Thomas Jefferson makes the following point: "We may consider each generation as a distinct nation, with a right, by the will of its majority, to bind themselves, but none to bind the succeeding generation, more than the inhabitants of another country."¹³

Jefferson elaborates on this point as follows:

The question Whether one generation of men has a right to bind another, seems never to have been started either on this or our side of the water. Yet it is a question of such consequences as not only to merit decision, but place also, among the fundamental principles of every government . . . [N]o such obligation can be transmitted, . . . the earth belongs . . . to the living . . .¹⁴

By reviewing statistics of his time (1789), Jefferson determined that the average life expectancy of those still living at age 21 was 55.¹⁵ He reasoned that, since the majority of those 21 year-olds who belonged to a particular generation would be dead 19 years after entering into a social contract with the state, the contract becomes void after 19 years.¹⁶ This rule applies to constitutions, public debt and all laws. Every law and constitution expires naturally at the end of that time, and any law or constitution that is enforced beyond that time is done so by force and not because of right.¹⁷ Thus, there is a strong philosophi-

12. The Sixteenth Amendment to the U.S. Constitution, which made income taxation constitutional, was passed in 1913. Before that, the government raised the money it needed through excise taxes and tariffs.

13. Letter from Thomas Jefferson to John Wayles Eppes (Monticello, Virginia, June 24, 1813), reprinted in THOMAS JEFFERSON: WRITINGS 1280, 1280-1281 (1984).

14. Letter from Thomas Jefferson to James Madison (Paris, France, September 6, 1789), reprinted in THOMAS JEFFERSON, *supra* note 13, at 959.

15. *Id.* at 960.

16. THOMAS JEFFERSON: WRITINGS, *supra* note 13, at 1281:

The period of a generation, or the term of its life, is determined by the laws of mortality, which, varying a little only in different climates, offer a general average, to be found by observation. I turn, for instance, to Buffon's tables, of twenty-three thousand nine hundred and ninety-four deaths, and the ages at which they happened, and I find that of the number of all ages living at one moment, half will be dead in twenty-four years and eight months. But (leaving out minors, who have not the power of self-government) of the adults (of twenty-one years of age) living at one moment, a majority of whom act for the society, one half will be dead in eighteen years and eight months. At nineteen years then from the date of a contract, the majority of the contractors are dead, and their contract with them.

17. THOMAS JEFFERSON: WRITINGS, *supra* note 13, at 962-63.

cal argument that even laws that are enacted by majorities—or unanimously—expire after some period of time because one generation cannot bind another. Even if one subscribes to a social contract theory, by which some majority can bind everyone, the contract has a limited life. One generation cannot *justly* bind another.

The concept of majoritarianism is another issue that must be addressed regarding the obligation of citizens to the state. Under majoritarianism, if 51% vote some item into law, the other 49% are reluctantly bound by that decision. Majoritarianism is a basic weakness of democracy, a pragmatic compromise, but it is endured so that democracy can function. If unanimous consent were required for everything, governments would not be able to function. But the fact that a law is approved by a majority does not mean that it is not coercive, because a large minority might disapprove of the law.¹⁸ And in cases where democracy is representational rather than direct, it sometimes happens that the people's representatives pass a law of which the majority of citizens does not approve.

The concept of majoritarianism is tied in with the concept of a social contract, the view that the people have entered into a contract with the state and that they can bind all of society. They exchange a portion of their freedom for the benefits the state provides. Hobbes and other social contract theorists argue that individuals give up all of their rights in exchange for state benefits.¹⁹ Another branch of social contract theorists, such as John Locke,²⁰ have argued that individuals give up some of their rights and that they can reclaim these rights if the state fails to do its job.²¹ Locke's view is the one represented in the U.S. Declaration of Independence.²²

Any social contract theory suffers from several flaws. In fact, one may even go so far as to say that there is no such thing as a social contract, and that such agreements, even if they did exist at one time in the distant past, are not binding on anyone who did not agree to their terms. It is a well-established principle of common law that one person cannot enter into a contract that binds another, except in the case of a partnership or corporation.²³ So it appears that

18. One advantage of a democracy over a dictatorship is that, under a dictatorship, one person tyrannizes the other 99.99%, whereas under a democracy, at worst, 51% tyrannize the other 49%. Herbert Spencer expresses a similar view in *SOCIAL STATICS* 189 (1970). He also expresses that view on page 210 of the 1851 London edition. Others would say that the difference between a democracy and a dictatorship is the number of feet on your throat.

19. THOMAS HOBBS, *LEVIATHAN* (1651).

20. JOHN LOCKE, *TWO TREATISES ON GOVERNMENT* (1689).

21. *See also* JEAN JACQUES ROUSSEAU, *THE SOCIAL CONTRACT* (1762).

22. *THE DECLARATION OF INDEPENDENCE* (U.S. 1776).

23. Lysander Spooner makes the following statement:

The Constitution has no inherent authority or obligation. It has no authority or obligation at all, unless as a contract between man and man. And it does not so much as even purport to be a contract between persons now existing. It purports, at most, to be only a contract between persons living eighty years ago. And it can be supposed to have been a contract then only between persons who had already come to years of discretion, so as to be competent to make reasonable and obligatory contracts. Fur-

those who would say that taxation is not coercive because “the people” consented to it are standing on shaky philosophical ground. Taxation is no more or less coercive any law which forces people to part with their property without their explicit consent.

In a society where freedom and private property are valued, voluntary forms of revenue raising are superior to coercive forms. If government is viewed as the servant rather than the master of the people, then coercion should be minimized and the possibilities for voluntary exchange maximized. Forms of revenue raising (like lotteries and user fees) that do not depend on coercion should be preferred to forms of revenue raising that rely on coercion. Thus, it follows that tax laws that expire after some period of time should be preferred to tax laws that remain on the books until repealed, because of the consent factor. The legislature should be required to decide, periodically, whether the tax laws should be renewed. While this requirement would not solve the consent problem completely, it would at least be a step in the right direction since the degree of consent that any law enjoys declines with each passing day as a portion of the citizenry dies and new citizens are born.

One argument against voluntarism in the area of government finance is that the government cannot raise all the funds it needs through voluntarism. Coercion is necessary for the state to function. While this issue is too broad to be fully addressed in a paper of this nature, a few points can be made here. First, this line of reasoning is pragmatic rather than philosophical or ethical. Simply stated, this pragmatic view holds that coercion is necessary in order to raise the necessary funds, therefore coercion must be used. Fairness, equity, and property rights are totally absent.

Second, even if one concedes the point that coercion is needed to raise the “necessary” funds, one must still ask “how much is necessary?” If the goal of a free society is to minimize coercion and allow maximum room for individual choice, then government expenditures must be kept at a minimum so that the amount of coercion needed to raise funds is minimized. Thus, the role of government must be minimized.

thermore, we know, historically, that only a small portion even of the people then existing were consulted on the subject, or asked, or permitted to express either their consent or dissent in any formal manner. Those persons, if any, who did give their consent formally, are all dead now. Most of them have been dead forty, fifty, sixty, or seventy years. *And the Constitution, so far as it was their contract, died with them.* They had no natural power or right to make it obligatory upon their children. It is not only plainly impossible, in the nature of things, that they could bind their posterity, but they did not even attempt to bind them. That is to say, the instrument does not purport to be an agreement between any body but “the people” then existing; nor does it, either expressly or impliedly, assert any right, power, or disposition, on their part, to bind anybody but themselves.

LYSANDER SPOONER, NO TREASON: THE CONSTITUTION OF NO AUTHORITY, *originally self-published by Spooner in Boston (1870), reprinted by Rampart College (1965, 1966, & 1971), and by Ralph Myles Publisher, Inc., Colorado Springs, Colorado (1973).* The quote is from page 1 of the 1971 edition (p. 11 of the 1973 edition). The constitution Spooner is referring to is the U.S. Constitution, which was adopted about eighty years before he wrote this essay. Emphasis is in the original.

As numerous studies have pointed out, most of what government does can be done more efficiently and cheaply by the private sector.²⁴ While minimizing the role and size of government is a worthy goal, it is easier said than done. But, regardless of the size of government, the tax system can be used to reduce the amount of coercion if voluntary means of raising revenue are used first, and then coercive methods are used only to make up the difference.

2. *Two Competing Views of Taxation*

There are two basic and diametrically opposed views of taxation. Those who favor the "ability to pay" approach view the state as a master who extracts tribute from its subjects on the basis of how much they are able to pay. They often also view the state as a benevolent father figure who distributes tax benefits on the basis of need. In Karl Marx's words, "From each according to his abilities; to each according to his needs."²⁵

Those who favor the cost-benefit approach view the state as the servant of the people. Government provides services; taxpayers pay for the services. Those who benefit the most from the services should pay the most. Those who do not use a particular government service should not be forced to pay for it.²⁶

A corollary to the cost-benefit principle is that there should be some maximum tax, an amount above which no one should have to pay. Leona Helmsley, for example, who went to prison for tax evasion,²⁷ would not have been punished if the U.S. tax system were set up under a cost-benefit principle because the amount of taxes she paid—more than \$100 million—exceeded the benefit she received. Under the cost-benefit principle, she would have been entitled to a refund. But, because she paid a few million dollars less than she "owed" under the graduated, ability-to-pay system, and because she resorted to illegal means to prevent the government from assessing the "proper" amount, she was sentenced to prison. It is difficult to believe that she received more than \$100 million in services from the federal government over the years. It seems like a clear case of the government exploiting one of its more productive citizens.²⁸

24. The growing body of privatization literature points this out clearly. For examples, see POOLE, *supra* note 3; FITZGERALD, *supra* note 3; BENNETT & JOHNSON, *supra* note 3.

25. KARL MARX, *CRITIQUE OF THE GOTHA PROGRAM* (1875). The original wording was "Jeder nach seinen Fähigkeiten, jedem nach seinen Bedürfnissen." Louis Blanc, the French socialist, said basically the same thing in 1848. GEORGE SELDES, *THE GREAT THOUGHTS* 274 (1985).

26. There are problems with both of these approaches. There is no way to objectively determine what someone's ability to pay is, so it must be decided arbitrarily. And there is no way to determine how much benefit someone receives from government services that are made available even if few people want them, since the price of such services is determined by bureaucratic fiat rather than through voluntary exchange.

27. *United States v. Helmsley*, 941 F.2d 71 (2d Cir. 1991).

28. Ross Perot, during one of the televised U.S. presidential debates in October, 1992, announced that he had paid \$1 billion in taxes over the years. One must wonder how the federal government could possibly provide him with \$1 billion in services. It seems unlikely that he could get his money's worth even if the government provided him with a large home, free clothing and ten meals a day. But he makes too much money to even qualify for welfare, so he is not able to get food or housing from the government.

The ability to pay principle is based on the theory of exploitation, in which the government is the exploiter and the most productive members of society are the exploited. These most productive citizens have a greater portion of their wealth confiscated and redistributed to those who consume government services. Thus, it is a parasitical system.

On the other hand, the cost-benefit approach makes some attempt to match costs with benefits. Those who use government services pay for them, and those who do not use the services are not forced to pay. Thus, the cost-benefit principle appears fairer than the ability to pay principle because it is based on principles of equity rather than exploitation. So, other things being equal, a tax that is based on the cost-benefit principle should be preferred to a tax that relies on the ability to pay principle, all other things being equal.

However, taxes raised either under the ability to pay approach or under the cost-benefit approach are generally raised by the use of force or the threat thereof. An exception is the case where the method used is a user fee or lottery. While both methods suffer from defects, the cost-benefit approach at least attempts to match costs and benefits equitably. By contrast, the ability to pay concept makes no such attempt.

3. *Should Taxes Be Visible or Hidden?*

A tax can be either visible or hidden. The merit of each approach depends on the goal of the individual making the determination. If the goal is to raise as much revenue as possible, with a minimum of protest, then a hidden tax should be preferred to a visible tax. If the goal is to restrain the amount of tax the government takes or to let taxpayers know exactly what they have to pay for government services, then a visible tax is more likely to help achieve that goal.

From a strictly moral point of view, a visible tax is preferable to a hidden tax. Disclosure should be as full and complete as possible. Disclosure is required on corporate financial statements so investors will know something about the stock they are buying. Product labeling laws force manufacturers to disclose the contents of the package.²⁹ Bankers are required by law to reveal the full interest charges on the loans they make. People should know the full cost of what they have to pay for government. If they do not, they will not be able to make intelligent decisions at election time.

An example of a hidden tax is a value added tax that is assessed on producers. The value added tax is hidden because the people who ultimately pay it—consumers—do not know what portion of their purchase is for the product and what portion is for the tax. As a result, they may tend to blame the company

29. I am not advocating that there should be labeling laws, but am merely using labeling laws as an example. Free speech advocates would be quick to point out that forcing companies to disclose the contents or ingredients of their products violates their right to free speech, or their right to refrain from speech. In cases where pharmaceutical companies must reveal the contents of their drug, there is also a possibility that their property rights are being violated, since they have a property right—a patent—for the products they produce.

that makes or sells the product for the high price when, in fact, a significant portion of the price represents a tax. Excise taxes on alcohol, tobacco and gasoline are examples of hidden taxes. The tax may be stated on the package or at the gas pump; however, consumers seldom read these things. The tax they pay is part of the stated price.

An example of a visible tax is a user fee. If people have to pay \$4 to enter a national park, they are made aware immediately of the cost of that particular government service. It is not hidden. But if admission is free, the real cost is hidden. Someone has to pay to maintain the park, to pay the salaries of the employees who work there, and so forth. If the cost of maintaining the park is funded through general tax revenues, those who use the park for free are being subsidized at the expense of everyone else. The result is overuse of the park. If individuals had to pay the full cost of using the facility, fewer of them would use it. This would have beneficial effects on the environment which is being harmed by overuse of government-owned recreational facilities.

Some taxes are partly visible and partly hidden. For example, the personal income tax in the United States is collected by having the employer take the tax directly from employee paychecks before they even receive their pay. The amount of the tax taken is disclosed on the pay stub, but employees do not feel the full "bite" of the tax because they never actually see the money. The tax would be more visible if employees had to write out a check to the government for the amount they owe. Such a requirement would place more pressure on politicians to keep taxes low, since taxpayers would have a better feel for what they were actually paying for government services. However, such a requirement would also increase collection problems since not everyone would pay the tax when it became due. But where there is a tradeoff between disclosure and efficiency, the ethical choice is disclosure. If the government is the servant of the people, then the people should know exactly how much their servant costs. The full cost should not be hidden even if the tax collection process would run more smoothly without disclosure. In the long-run, a full disclosure system would probably result in lower taxes since taxpayers who are aware of the full cost of government will have a tendency to pressure their representatives to keep taxes low.

4. Should Government Support or Discourage Certain Activities?

Governments sometimes use tax policy to encourage or discourage certain kinds of activity. High excise taxes are imposed on alcohol and tobacco products, for example, to discourage the use of these products. Taxes are imposed on gasoline products not only to raise revenue but also to conserve energy. Special tax treatment is given to certain groups such as farmers or for certain economic activity such as the purchase of equipment to encourage or subsidize this group or that. The question is whether it is a good idea to use the tax system for something other than raising funds for government operations.

One author states, "A range of tax advantages and preferences must be used to stimulate and encourage activities of genuine value to society, in clearly defined directions."³⁰ However, the problem with using the tax system as a tool of industrial policy is that governments that have an industrial policy have historically tended to pick losers rather than winners. Governments have tended to subsidize old, dying, inefficient industries and to neglect new, innovative industries that have real growth potential. Supporting losers is inherent in the system because it is the losers—the steel, auto and textile industries, in the United States, for example—that have acquired power and influence with the legislature over the years. The newer industries have not acquired such influence because they are still small and they have not been around as long.³¹

The tax system in the United States also discourages marriage. For example, if a single man and a single woman each earn \$40,000, they will pay less total tax as unmarried individuals than they would if they were married and filing a joint tax return. When the differential tax rate structure was constructed, it was not the intent to penalize individuals for being married. The idea behind the differential rates was that two people who share expenses (such as a married couple) have a better ability to pay taxes than do two individuals who live apart and must support themselves without the assistance of another individual. But the effect is to penalize married couples by assessing them a higher tax.

The same policy is applied to social security payments in the United States. A married couple receives less in total social security benefits than would two single individuals. As a result, some couples who have been married for decades get divorced when they start collecting social security benefits so they can qualify for higher payments. However, they continue to live together and consider themselves married for all other purposes. The obvious solution to this problem is to remove the marriage penalty so that people do not have to pay higher taxes if they want to be married. Government policy should neither encourage nor discourage marriage—it is not the government's business to encourage or discourage any lifestyle.

30. V. Rodiushkin, *Tax Reform and Structural Change*, in *THE ROLE OF TAX REFORM IN CENTRAL AND EASTERN EUROPEAN ECONOMIES* 41 (OECD ed., 1991).

31. For discussion on the failures of industrial policy, see JOHN BURTON, *PICKING LOSERS: THE POLITICAL ECONOMY OF INDUSTRIAL POLICY* (1983); KRISTIAN S. PALDA, *INDUSTRIAL INNOVATION: ITS PLACE IN THE PUBLIC POLICY AGENDA* (1984); RICHARD B. MCKENZIE, *NATIONAL INDUSTRIAL POLICY: COMMENTARIES IN DISSENT* (1984); William A. Niskanen, *A "Supply Side" Industrial Policy*, 4 *CATO J.* 381 (1984); Israel M. Kirzner, *Economic Planning and the Knowledge Problem*, 4 *CATO J.* 407 (1984); Don Lavoie, *Two Varieties of Industrial Policy: A Critique*, 4 *CATO J.* 457 (1984); Josef C. Brada, *Industrial Policy in Hungary: Lessons for America*, 4 *CATO J.* 485 (1984); Katsuro Sakoh, *Japanese Economic Success: Industrial Policy or Free Market?*, 4 *CATO J.* 521 (1984); Edwin Vieira, Jr., *The Constitutional Chaos of Industrial Policy*, 4 *CATO J.* 549 (1984); Thomas J. DiLorenzo, *The Political Economy of National Industrial Policy*, 4 *CATO J.* 587 (1984); James C. Miller, III, *The Case Against "Industrial Policy,"* 4 *CATO J.* 651 (1984).

C. *Economic Issues*

1. *Tax Rates*

High income tax rates are a major disincentive to production, savings and wealth accumulation. For example, if a painter in the 90% marginal tax bracket³² is offered a commission to paint a portrait for \$10,000, he will only be able to keep \$1,000 for his efforts if he accepts the work. In effect, he has the option of working for below market prices or not working at all.³³ It is reasonable to expect that, in some cases, he will decide not to take the work. So the painting will never come into existence. Or perhaps he will take the commission but not declare the income, which increases the amount of tax evasion in the economy and decreases respect for the law.³⁴

High estate tax rates discourage savings and investment. If 90% of one's assets are confiscated by the government at death, there will be a tendency to spend it all now and not leave much for the heirs. As a result, capital accumulation suffers under a high estate tax regime. This, in turn, has a negative effect on economic growth as well as the standard of living. Of course, one might give one's assets to one's children and grandchildren before death, but this route may not be possible if a gift tax takes a large chunk of the gift.

From a taxpayer standpoint, low rates are superior to high rates. From the government's perspective, high rates may be more attractive than low rates because more revenue can be collected from high rates than from low rates. However, while this may be true over a certain range of rates, it is not true in all cases. People will change their behavior if rates are too high. Consequently, total revenue generated may actually decline. For example, if the marginal individual income tax rate rises to 100%, individuals will quit working second jobs and will refuse to work overtime, even if they would receive premium pay. Additionally, there will be tremendous incentives not to report all income, thus increasing the extent of tax evasion. If the rate is only 90%, the same behavior will occur to a somewhat lesser degree. If the top rate is 5%, people will be willing to work harder and longer because they will keep most of the fruits of

32. Marginal tax rates in the United States and other places (like England) have been as high as 90% or more at times. In some cases, rates have exceeded 100%, as where someone in the 93% bracket is assessed a 10% surcharge.

33. Mark Skousen has a similar example in *ECONOMICS ON TRIAL*, *supra* note 7, at 159.

34. The subject of tax evasion presents some interesting ethical and philosophical questions. If taxation is theft, then there is no ethical duty to pay taxes, just as there is no ethical duty to turn over your property to a thief. And taxation is similar to theft in some ways, since in both cases, the owner's property is being taken without consent. But in the case of robbery, it is a one-time thing, whereas in the case of taxation, the transfer is periodic and continuous, which makes it more akin to slavery, since, in essence, it is the fruits of one's labor that are being taken. The Roman Catholic Church recently issued a new catechism, the first since 1566. *Sins, Ancient and Modern*, *THE ECONOMIST*, Nov. 21, 1992, at 50; *New Rules for an Old Faith*, *NEWSWEEK*, Nov. 30, 1992, at 71. This catechism lists tax evasion as a sin. But theologians over the centuries have often said that there is no moral duty to pay taxes, at least in some situations. For one of the most comprehensive treatises on the ethics of tax evasion, see *REV. MARTIN T. CROWE, THE MORAL OBLIGATION OF PAYING JUST TAXES* (Cath. U. of Am. Stud. in Sacred Theology No. 84, 1944).

their labor. But if the top rate is only 5%, the state may not be able to collect all the revenue it needs to pay its expenses. Somewhere between 0% and 100% there is an optimum rate that will maximize tax collections.³⁵

While there is a relationship between the amount of taxes collected and the tax rate, there are a number of problems with this "optimum tax rate" approach. For one thing, there is no way to measure precisely what the optimum rate is. Individuals have different preferences and their preferences change from time to time. Those preferences are not known and cannot be measured. Some people would continue to work if 93% of their income were taxed away; some would not. Some would work for a few extra hours; some would work for even more. Hence, arriving at an optimal tax rate is almost pure guesswork.

Another, perhaps larger, problem also exists with this search for an optimum tax rate. It involves the philosophical question of whether it is even proper for a government to attempt to extract the maximum amount of taxes from the citizenry. If government is the servant rather than the master of the public, then it would seem that attempting to extract the maximum tribute from taxpayers is an illegitimate goal. Servants have no inherent right to extract (by force) some maximum income from their masters. Neither do governments, which are the servants of the people, have such a right.

The tax rate also affects the economy. Money taken out of the private sector cannot be used to invest in business expansion, or to purchase consumption items. A number of studies have concluded that high tax rates retard economic growth and low rates encourage it.³⁶ Economic growth cannot come from raising taxes. Raising taxes only redistributes previously created wealth. If maximizing economic growth is a goal, minimizing taxes must be part of the way to achieve that goal. Thus, lower rates are better than higher rates.

There is also a relationship between economic efficiency and the tax rate. If rates are high, businesses will lose less if they make a bad investment decision because they can deduct the loss on their tax return. Therefore, there is a tendency to be less careful about making investments. And, when the tax system has high rates and is complex, as was the case in the United States before the 1986 Tax Reform Act,³⁷ there tends to be a number of "tax shelters"—invest-

35. This relationship between tax rates and tax revenues is called the Laffer Curve, named after Arthur Laffer, an economist who spoke about this relationship. The Laffer Curve is discussed in many places, including CAMPBELL R. MCCONNELL & STANLEY L. BRUE, *ECONOMICS* 389-391 (11th ed. 1990).

36. Alan Reynolds, *International Comparisons of Taxes and Government Spending, in RATING GLOBAL ECONOMIC FREEDOM* 366 (Stephen T. Easton & Michael A. Walker eds., 1992). Reynolds refers to the following studies: Alan Reynolds, *Some International Comparisons of Supply-Side Tax Policy*, 5 CATO J. 543 (1985); Alvin Rabushka & Bruce Bartlett, *Tax Policy and Economic Growth in Developing Nations* (U.S. Agency for Int'l Dev. ed., 1986); JUDE WANNISKI, *THE WAY THE WORLD WORKS* (1978, 1983 & 1989). Other studies that reach the same conclusion include KEITH MARSDEN, *LINKS BETWEEN TAXES AND ECONOMIC GROWTH: SOME EMPIRICAL EVIDENCE* (World Bank Staff Working Papers No. 605, 1983); GARY & ALDONA ROBBINS, *PROMOTING GROWTH THROUGH TAX POLICY* (Institute for Pol'y Innovation Rep. No. 115, 1992).

37. Pub. L. No. 99-514 (1986). For a technical exposition of this law, see A COMPLETE GUIDE TO THE TAX REFORM ACT OF 1986 (Prentice-Hall Info. Services ed., 1986). The Tax Reform Act of

ments that make no economic sense but make good tax sense. For example, under a tax shelter scheme that has a 5-to-1 write-off, every \$100 investment results in a \$500 tax deduction. If the tax rate is 50%, an investor can reduce his taxes by \$250 (50% of \$500) by making a \$100 investment, which is a better return than could be had from most legitimate investments that would create real economic wealth.

It has been argued that raising tax rates can have a beneficial effect on the economy when the economy is nearing full employment and becoming "overheated." Keynes³⁸ and others³⁹ have argued that fiscal policy—raising taxes—can be used to reduce this overheating and ease inflation. This view is based on the theory that inflation is caused either by excess demand or increasing costs. Economists call these two causes of inflation "demand-pull" and "cost-push."⁴⁰ But this view has been discredited.⁴¹ It is possible to have both unemployment and inflation at the same time.⁴² Evidence suggests that inflation is caused by an increase in the quantity of money, not by excess employment or excessively low tax rates.⁴³ Such evidence casts grave doubts on the assertion that high tax rates may be justified for reasons of economic growth.

Therefore, low tax rates are preferred to high rates for a number of reasons. Low rates result in less distortion to the economy because less money is being taken from producers and redistributed to tax consumers. Resources are not being squandered on tax shelters that make no economic sense. Low rates aid in economic growth because more money is available for investment. Low rates are fairer than high rates because low rates involve less confiscation of personal property.

1986 did not reduce complexity. It might be fair to say that the Act actually increased complexity, at least in some areas of the tax code. But it also reduced tax rates, which reduced the incentive to invest in tax shelters, since investing in tax shelters makes no sense when tax rates are low.

38. JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* (1936).

39. At least one economist has gone so far as to say that "taxes are needed not to provide governments with money but to take money away from the public." See BIRD, *supra* note 4, at 4. This statement seems a bit extreme, even for a Keynesian.

40. For an exposition of this view, see any economics textbook.

41. See, e.g., W.H. HUTT, *THE KEYNESIAN EPISODE: A REASSESSMENT* (1979); W.H. HUTT, *KEYNESIANISM: RETROSPECT AND PROSPECT* (1963); HENRY HAZLITT, *THE FAILURE OF THE "NEW ECONOMICS"* (1959); *THE CRITICS OF KEYNESIAN ECONOMICS* (Henry Hazlitt ed., 1960); *DISSENT ON KEYNES*, *supra* note 5.

42. The evidence from the 1970s in the United States provides ample proof of this relationship. The Phillips Curve, which shows a negative relationship between unemployment and inflation, has been discredited. See MILTON FRIEDMAN, *UNEMPLOYMENT VERSUS INFLATION? AN EVALUATION OF THE PHILLIPS CURVE* (Institute of Econ. Affairs Occasional Paper No. 44, 1975); MILTON FRIEDMAN, *INFLATION AND UNEMPLOYMENT: THE NEW DIMENSION OF POLITICS* (Institute of Econ. Affairs Occasional Paper No. 51, 1977); Jeffrey M. Herbener, *The Fallacy of the Phillips Curve*, in *DISSENT ON KEYNES*, *supra* note 5.

43. The view that inflation is caused by an increase in the supply of money is called the monetarist view or the quantity theory, as opposed to the Keynesian view. The monetarist view is not new. It has been in existence for hundreds of years and provides a better explanation for the cause of inflation than have other theories. Milton Friedman is one of its strongest exponents. See MILTON FRIEDMAN, *A PROGRAM FOR MONETARY STABILITY* (1960); MILTON FRIEDMAN, *ESSAYS IN POSITIVE ECONOMICS* (1953); HANS F. SENNHOLZ, *AGE OF INFLATION* (1979).

2. *Should Tax Rates Be Uniform or Discriminatory?*

Policymakers can structure the tax system in one of three ways. The first option is a discriminatory rate tax, which takes a larger percentage from some groups than others. An example is a graduated personal income tax. A graduated tax takes a larger percentage of marginal income from upper income groups and a lesser percentage from those who earn less. For example, a graduated system might take 5% of taxable income between \$0 and \$5,000, 10% of taxable income between \$5,001 and \$10,000, 20% of taxable income between \$10,001 and \$20,000, and 30% of taxable income over \$20,000. Such a system can be complex; it may have ten or more different rates depending on income level. Or, this system can be relatively simple; it may have just two or three rates.

A graduated system discriminates against those who earn more. Such a system is based on the ability to pay philosophy rather than the cost-benefit principle. As mentioned above, the cost-benefit principle is preferred to the ability to pay principle.

Economists have presented a number of utilitarian arguments against the graduated income tax.⁴⁴ They say it destroys incentives of the most productive people. And, because it is primarily the most productive people who save, invest, and create jobs, a graduated tax will retard economic growth by reducing the amount of capital available for investment. Such a system is not only economically inefficient but also exploitative because it is based on ability to pay. Hence, a graduated tax is less desirable than one that has the same rate for everyone. This is not only because of fundamental fairness, but also because it is simpler, and simplicity is preferred to complexity.

The second option is a tax that has just one, uniform rate. An example is the flat rate income tax.⁴⁵ One advantage of the flat tax lies in its simplicity; everyone pays the same rate. If the flat rate is 10%, then someone with \$20,000 in taxable income will pay \$2,000 and someone with \$2,000,000 in taxable income will pay \$200,000. Thus, although the rich will pay more in total than the poor, they will pay the same percentage.

One might argue that, in fairness, the rich should pay more in total than the poor because the rich have more property to protect than the poor. That is, since protecting property is a function of government, those with more property should pay more for government services than those who own less property. This logic seems reasonable on the surface. But problems appear if one digs deeper. For one thing, there may be little or no relationship between the cost of protecting property and the amount of property to be protected. It may cost

44. For examples, see WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953); F.A. Hayek, *The Case Against Progressive Income Taxes*, FREEMAN 229-32 (1953).

45. ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (1985). Since no tax is neutral, any change in tax policy will have winners and losers. For a discussion of this point as applied to the flat tax, see Murray N. Rothbard, *The Case Against the Flat Tax*, in *THE FREE MARKET READER* 342-62 (1988).

more to protect 100 acres of land worth \$10,000 than to protect a bank vault that contains \$100 million.⁴⁶ But at least a flat tax makes some attempt at equity, whereas a graduated tax is grounded in the theory of exploitation.

Another advantage of a flat rate is that it does not penalize those who are more productive.⁴⁷ Therefore, it does not have as much of an adverse effect on incentives and capital formation as a graduated rate (especially if the rate is low). A flat tax also does not adversely affect social harmony as much, since it does not pit one class against another—the rich against the poor.

The third option is a tax that charges everyone the same amount. An example is a poll tax or a head tax.⁴⁸ For example, if the total cost of providing government services in a particular community is \$1,000,000 and there are 10,000 people in the community, then every individual would be assessed a tax of \$100. This form of tax comports with the cost-benefit principle. Assuming everyone benefits equally from government services, then everyone should pay the same amount regardless of income. Otherwise, the system may encourage free riders.

This form of tax is the closest approximation to a market system. For example, if you go into a store to purchase a loaf of bread, the person behind the counter does not ask what your income is before quoting a price for the bread. The price you pay for the bread is not based on a percentage of your income. The price is the same for everyone regardless of income level—like the poll tax. But the poll tax is not neutral because some people benefit from government services more than others. And if everyone received \$100 worth of services in exchange for a \$100 poll tax, why have a tax in the first place? Why not just abolish taxation and eliminate the middle man (government) and allow everyone to buy \$100's worth of services?

While a poll tax may be the fairest of the three options, imposing a poll tax has historically resulted in problems. Margaret Thatcher tried to impose a poll tax in England and triggered vehement public reaction. Those who would pay more under a poll tax scheme protested loudly (and sometimes violently). Part of the problem was that the poll tax is a visible direct tax; people knew exactly what they were paying. On the other hand, when the total cost of the tax is hidden, people do not realize what they are really paying. As a result, there is less probability that people will protest. There appears to be an irreconcilable conflict between fairness and feasibility when it comes to implementing a poll tax, especially if some people (such as the poor, unemployed or retired) cannot afford to pay. One way to increase both fairness and feasibility would be to reduce the amount of the tax. Another way would be to replace coercive taxes

46. See MURRAY N. ROTHBARD, *POWER AND MARKET: GOVERNMENT AND THE ECONOMY* 115 (1970).

47. This statement is not quite accurate. It would be more precise to say that the rich are not penalized any more, percentagewise, than the poor. But all groups who earn income are penalized in the sense that a portion of their income is taken from them.

48. J.G. Cullis et al., *Public Choice Perspectives on the Poll Tax*, 101 *ECON. J.* 600 (1991).

like the poll tax with voluntary forms of public finance, such as lotteries and user fees.

3. Administration

A tax that is easy to administer should be preferred to one that is difficult to administer, all other things being equal. While this might seem obvious, many of the taxes now being imposed in the so-called advanced Western democracies are difficult rather than easy to administer. Complexities have crept into the system, making tax administration much more difficult than need be.

Emerging economies should be aware of this so as to avoid similar problems when they construct their own tax systems. The finance ministries of emerging economies should not blindly follow the advice of Western tax experts, who constructed the overly complex systems that now burden the West. In Poland, for instance, the Internal Revenue Service of the United States has been called upon to provide instruction to Polish economists and tax collectors about the intricacies of the United States tax system.⁴⁹ To many people who are familiar with the needless complexity of the US tax system, the idea of such instruction triggers responses ranging from hilarity to worry, fear, and disgust.

4. Collection

A tax may be either easy or difficult to collect. From the collector's point of view, easy is better than difficult. The ease with which a tax may be collected is most relevant to devising a tax system. In most Western democracies, corporate income taxes, individual income taxes that are withheld by employers, and sales taxes are relatively easy to collect because business entities collect the taxes and turn them over to the government. Tax liabilities generated from participants in the underground economy are much more difficult to collect. Low taxes are generally easier to collect than high taxes because there is less resistance to paying low taxes than to paying high taxes. If those who design the tax system choose to impose a tax that is difficult to collect, they must budget large sums for tax administration and enforcement. This inefficiency could also have a detrimental effect on civil liberties.

5. Earmarking Taxes

Taxes can either go into the general fund or they can be earmarked, i.e. set aside for particular purposes. Income taxes are generally deposited into the general fund to be used for a variety of purposes. However, some taxes are set aside for a particular purpose. For example, funds from gasoline taxes are often used to maintain highways. Another example of an earmarked tax would be if a portion of cigarette taxes were used for cancer research.

49. *Officials Outline IRS Help in Setting Up Polish Tax System*, DAILY TAX REP. (BNA) G-1 (Apr. 6, 1992).

Whether revenues from a particular tax should be placed into the general fund or earmarked for special purposes depends on a number of factors. A tax increase will be more acceptable to the general population if it is earmarked for a widely accepted purpose.⁵⁰ Examples include lottery proceeds that are used for education and Social Security taxes that are set aside for taxpayer retirements.⁵¹ One advantage of earmarking tax collections is that segregating tax revenue for specific purposes reduces the possibility that the money will be squandered on pork barrel projects. Earmarking tax dollars is a good control device; it enhances the chances that the money will be spent for its intended purpose.⁵² However, earmarking is not a device that can be used for every kind of government expenditure. Dumping everything into a common pot gives the government more flexibility to shift spending as needed. Therefore, there is a trade-off between *flexibility* and *public reaction*.

6. *Distortional Effects of Taxes on the Economy*

From an economic perspective, the best tax is a neutral tax—a tax that does not divert the operation of the market from the lines it would take in the absence of taxation.⁵³ All other things being equal, the less distortion to the economy, the better the tax. Economic resources are allocated most efficiently if they are allowed to gravitate to their most highly valued uses. Anything that causes economic resources to be diverted from their optimum use causes inefficiency and retards economic growth. Economic disruptions cause a number of problems, many of which are unforeseen. The best tax is a tax that causes no distortion. However, there is no such thing as a purely neutral tax.⁵⁴

Distortion results when resources are taken away from their best and most efficient use and poured into uses that are less productive. High tax rates produce more distortion than low rates not only because high rates cause more funds to shift into relatively inefficient paths but because high rates cause individuals and businesses to shift their resources into areas that produce tax benefits rather than wealth. When the United States had relatively high tax rates, before the Tax Reform Act of 1986 (hereinafter “TRA”), high-income taxpayers resorted to numerous tax shelters in order to shield their income from the high

50. James M. Buchanan, *The Economics of Earmarked Taxes*, J. POL. ECON. 457 (Oct., 1963). Buchanan also discusses earmarking in PUBLIC FINANCE IN DEMOCRATIC PROCESS 72-87 (1967).

51. The Social Security taxes that are collected in the United States are not really set aside for the taxpayers' retirement. Those who work pay into the system and those who are retired draw from it, so the Social Security Trust Fund is not a true trust fund.

52. The argument could also be made that since earmarking identifies taxes with defined parts of public spending, earmarking can assist in achieving a closer assessment of individual preferences, improve compliance, stabilize revenue flows, and protect valuable public spending areas against less socially productive projects which, in an undifferentiated tax system, may crowd them out. For an exposition of this thesis, see RANJIT S. TEJA & BARRY BRACEWELL-MILNES, *THE CASE FOR EARMARKED TAXES: GOVERNMENT SPENDING AND PUBLIC CHOICE* (1991).

53. LUDWIG VON MISES, *HUMAN ACTION* 737 (3d ed. 1966).

54. Murray N. Rothbard, *The Myth of Neutral Taxation*, 1 CATO J. 519 (1981).

tax rates. After rates dropped, much of this money was shifted into taxable investments that produced wealth rather than tax deductions.

The 1986 TRA also had other less positive effects on the economy. The 1986 TRA has been cited as a major reason why the real estate industry in the United States went into a depression.⁵⁵ "In constructing the Tax Reform Act of 1986 legislators could not have done a better job of destroying this [real estate] market if they had consciously set out to do so."⁵⁶ The 1986 TRA made three tax law changes that, taken together, practically deflated the real estate industry overnight. The law eliminated the capital gains tax rate differential, eliminated the passive loss limitation rules, and lengthened the tax write-off period for real property. These changes eliminated much of the incentive to invest in real estate. Housing starts has dropped every year since. All housing starts dropped by 36% for the 1986-1990 period and multifamily housing starts dropped by 71%. This caused a ripple effect throughout the economy and sent thousands of housing construction workers to the unemployment lines.

The 1986 TRA changes also adversely affected the savings and loan industry.⁵⁷ Savings and loans ("S&Ls") were required by law to invest a certain percentage of their assets in mortgages. Consequently, the depression in the real estate market greatly devalued these S&L mortgages. This caused many S&Ls to become technically insolvent—the market value of their assets became less than the present value of their liabilities. Even those S&Ls that did not become technically insolvent saw their balance sheet positions weakened greatly. To further complicate matters, the government insurance fund that was established to protect investors from losing money in the event of an S&L bankruptcy (FSLIC) did not and still does not have enough funds to cover all the losses. Therefore, taxpayers must pick up the tab for the difference. Furthermore, since the S&L industry and banking industry have overlapping markets, the 1986 TRA is also having an adverse effect on the banking industry as well.

The Institute for Policy Innovation has estimated that the 1986 TRA had the following effects on real estate:⁵⁸

- Commercial real estate value fell by 17%.
- Home ownership value fell by more than 9%.
- Rental costs increased 17.5% because of the impact on commercial real estate.
- Capital gains changes when combined with lower marginal tax rates, decreased the value of an owner-occupied home worth more than \$150,000 by between 5% and 6.5%.⁵⁹
- Capital gains changes reduced the value of owner-occupied housing by about \$125 billion.

55. DESTROYING REAL ESTATE THROUGH THE TAX CODE (Institute for Res. on the Econ. of Tax'n Pol'y Rep. Bull. No. 48, 1991).

56. *Id.* at 1.

57. ALDONA & GARY ROBBINS, HOW TAX POLICY COMPOUNDED THE S&L CRISIS (Institute for Pol'y Innovation Pol'y Rep. No. 109, 1991).

58. *Id.*

59. It should be pointed out that the reduction in individual tax rates also had some beneficial effects in other sectors of the economy, such as freeing up more money for investment and consumption, and enhancing the incentives to work and produce wealth.

- Capital gains changes reduced commercial real estate values by 9%.
- \$35.6 billion of the estimated \$150 billion S&L bailout cost are due to the 1986 TRA.
- About \$21 billion of the \$35.6 billion in S&L bailout cost are due to the capital gains and passive losses changes.

Although some economists predicted that the 1986 TRA would have some of these effects, most or all of these consequences were unintended. Those in Congress who made the policy change were either not aware of the effect the policy change would have or did not give it much thought. Of course, one might argue that Congress subsidized real estate in prior years, which is true, since the special tax advantages Congress gave to real estate owners reduced their costs and increased their after-tax returns. One might further argue that Congress has no business subsidizing or penalizing any economic activity (as I argue above). In the case of real estate, as with so many areas of economic activity (such as oil and gas taxation, the child care credit, the investment tax credit, the research tax credit, and so forth), government subsidies have distorted the market. The 1986 TRA, in effect, reduced the subsidy the previous tax code provided to real estate. It is a good illustration of what can happen when government initially provides a subsidy and later takes it away. Resources shift and those who were subsidized in the past get hurt. This is not to say that a government subsidy, once put in place, should never be removed. Rather, the government has no business subsidizing (or penalizing) any activity between consenting adults in the first place.

The lesson to be learned from these examples is that tax policy has consequences. There is no such thing as a neutral tax. Policymakers should carefully consider what effects a particular tax policy will have on all segments of the economy.

7. Effects of Taxes on Competitiveness and Economic Growth

Tax policy has an effect on competitiveness and economic growth. This aspect of tax policy is especially important to emerging economies, because the transformation from a centrally planned economy to a market economy entails major shocks to the economic system. As a general rule, it can fairly be stated that emerging economies have difficulty competing with more developed market economies either because they do not make the products that developed economies want or because the quality is too low and/or the price is too high. These difficulties can be greatly relieved by knocking down trade barriers and importing modern technology. Many of the emerging economies have skilled workforces that are willing to work at competitive wages if only the system would allow them to use their skills and energies.⁶⁰ It is important that these emerging economies adopt tax rules that make it easier for them to compete.

60. There are exceptions, of course. Some of the skills these people have acquired are of little or no use to a market economy. And living under generations of central planning, where jobs are guaranteed for life without regard to performance, has dampened the work ethic in some cases.

The tax system they adopt should promote rather than retard economic growth and development.⁶¹

Which tax policies would foster economic growth and development? The tax system should encourage investment, both foreign and domestic. Foreign companies should not be penalized for investing locally, and domestic companies should not find their own country's tax system more burdensome than those of other nations.⁶²

There are a number of factors that make a tax system attractive or burdensome. Companies would rather invest in a country that has low tax rates than high ones. A number of studies have shown that high tax rates retard economic growth.⁶³ For example, one study concluded that the tax increase President Bush signed into law in 1990 retarded economic growth by 0.7%, eliminated 400,000 jobs, caused the unemployment rate to be 0.45 percentage points higher than it otherwise would have been, and caused stock prices to drop by 15%. This study estimated that each 1.0% increase in the federal tax burden leads to a 1.8% reduction in economic growth.⁶⁴ Another study of the U.S. tax system estimates that modifying payroll deductions, adopting neutral cost recovery,⁶⁵ eliminating capital gains taxation, eliminating the tax on corporate dividends, and eliminating the taxation and deductibility of interest would add 1.1 percentage points to the economy's growth rate, increase gross domestic product by nearly \$6.2 trillion dollars between 1992 and 2000 (which translates into a roughly 13% increase in the standard of living), create nearly 4 million jobs between 1992 and 2000, and increase the stock of capital by \$10.4 trillion between 1992 and 2000.⁶⁶ In another study, researchers, using a model of the U.S.

61. A number of commentators have examined the U.S. tax system and have pointed to some policies that stifle growth and reduce competitiveness. For examples, see MARTIN NEIL BAILY & ROBERT Z. LAWRENCE, *TAX POLICIES FOR INNOVATION AND COMPETITIVENESS* (Council on Res. & Tech. ed., 1987); Anthony Baldo, *Killing the Goose: How Myopic IRS Tax Policies Are Crippling U.S. Competitiveness Abroad*, 158 *FINANCIAL WORLD* 16 (1989); *A Comparison of Japanese and American Taxation of Capital Gains*, 14 *HASTINGS INT'L & COMP. L. REV.* 719 (1991); Raymond Haas, *U.S. Tax Policies Hurt U.S. Multinationals*, 58 *CPA J.* 62 (1988); Bill Modahl, *How U.S. Corporate Taxes Hurt Competitiveness*, 15 *FINANCIER* 42 (1991).

62. Of course, tax policy is only one factor that affects the total cost of doing business in a particular country. Other factors also affect the general business climate, such as the presence (or absence) of the rule of law, the extent of regulation and how it is applied, corruption of government officials, infrastructure, skills of the workforce, peoples' attitudes toward work, and so forth.

63. Alan Reynolds, *International Comparisons of Taxes and Government Spending, in RATING GLOBAL ECONOMIC FREEDOM* 366 (1992). Reynolds refers to the following studies: Alan Reynolds, *Some International Comparisons of Supply-Side Tax Policy*, 5 *CATO J.* 543 (1985); Rabushka & Bartlett, *supra* note 36; WANNISKI, *supra* note 36.

64. WILLIAM C. DUNKELBERG & JOHN SKORBURG, *HOW RISING TAX BURDENS CAN PRODUCE RECESSION* (Cato Inst. Pol'y Analysis No. 148, 1991).

65. Neutral cost recovery refers to the straight-line depreciation method, the method by which equal chunks of an asset's cost are taken as depreciation expense over some period of time. Non-neutral depreciation methods are called accelerated methods. Accelerated methods take larger chunks of asset cost as depreciation expense in the early years and smaller chunks in later years. Some accelerated depreciation methods include the double-declining balance method, the sum-of-the-years-digit method, ACRS (accelerated cost recovery system) and MACRS (modified accelerated cost recovery system).

66. Robbins, *supra* note 36.

economy that took federal, state and local taxes into account, estimated that for every dollar of extra revenue raised, production declined by \$0.332.⁶⁷ A World Bank study of 20 countries found that those with lower tax rates had a more rapid expansion of investment, productivity, employment, and government services, and had better growth rates than countries that had higher rates.⁶⁸

However, one does not need to refer to studies to reach the conclusion that high tax rates retard economic growth. The conclusion can be reached *a priori*. It just makes sense that economic growth will be retarded if a large portion of a company's profits are siphoned off in taxes. The more money taken as taxes, the less will be available for further investment. If tax rates are high, companies will be less careful about how they spend their money, since they get a large discount on everything they buy. For example, if the corporate tax rate is 60%, the after-tax cost of a \$100 business lunch becomes \$40. But if the tax rate is only 10%, the after-tax cost is \$90. There tends to be less waste—and more efficiency—when tax rates are low because companies are more hesitant to squander money under a low rate regime because a large percentage of what they squander comes out of their own pocket.

The tax system should make it easy rather than difficult to accumulate capital. Ideally, there should be no tax on capital or capital gains. Or if there is one, it should be very low. The higher the tax on capital and capital gains, the more economic growth will tend to be retarded. Countries that have no or low capital gains taxes tend to have higher growth rates than those that have high capital gains tax rates.⁶⁹

67. The study was conducted by Charles Ballard, John Shoven and John Whalley, and was cited by James L. Payne in *Unhappy Returns: The \$600-Billion Tax Ripoff*, POL'Y REV. 21 (1992). Payne points out that, using this average 33.2% figure, the tax system in the United States caused production to be \$315.6 billion lower than it otherwise would have been in 1990.

68. KEITH MARSDEN, LINKS BETWEEN TAXES AND ECONOMIC GROWTH: SOME EMPIRICAL EVIDENCE (World Bank Staff Working Paper No. 605, 1983).

69. SKOUSEN, *supra* note 7, at 170-71. There are two different things involved here. One is the tax rate. The higher the rate, the less likely people will be able to sell their property, since selling would trigger the tax. The second factor is the way that capital gains taxes are computed, since a large part of the taxable gain might not be a real economic gain. For example, if someone bought a parcel of land in 1930 for \$1,000 and sells it in 1995 for \$3,000, the gain subject to the capital gains tax is \$2,000. But if prices have quadrupled since 1930, the purchasing power of the \$3,000 received upon sale is less than the purchasing power of the \$1,000 that was used to acquire the property in 1930 (\$1,000 in 1930 dollars is equivalent to \$4,000 in 1995 dollars if prices have quadrupled). There has been an economic loss, since the amount of purchasing power used to acquire the property is less than the amount of purchasing power received upon sale. Yet the sale is subject to tax, even though there has been a loss. This is one reason why many economists have called for either an outright repeal of the capital gains tax, or indexing so that only real economic gains are taxed, not paper profits.

If the capital gains tax prevents people from selling their property to those who can make efficient use of it, it prevents potential sellers from using the cash they would otherwise receive from investing in more productive activities, thus elongating the shift of assets from less efficient uses to more efficient uses.

8. Complexity

A tax system can have simple or extremely complex rules. Simple rules should be preferred to complex rules, all other things being equal. While this conclusion comes as no surprise, and may even seem not worthy of mention, it should be noted that many modern western democracies have rules that are far more complex than necessary to raise the amount of revenue that is raised.⁷⁰ Any emerging economy that looks to a western tax system for guidance should keep this fact in mind.

In the United States, for example, the Internal Revenue Code and Regulations run to many thousands of pages, often in small print.⁷¹ The regulations for many tax code sections run to more than 100 pages. Nor does the guidance end there. Tax practitioners and taxpayers who want to dig to the bottom of some tax issues must also consult not only with the thousands of tax cases that have been decided in three different federal court systems,⁷² but also with Internal Revenue Service publications and privately published tax treatises. Even then the answers are not always readily apparent. Thus, tax practitioners and taxpayers must sometimes guess at what the correct answer might be. To make matters even more unpredictable, sometimes the IRS issues a tax regulation retroactively. Thus, a tax rule that is issued in 1993 might take effect as of 1981.⁷³

Some tax rules in the United States are so complex that even IRS agents do not understand what the law says. A General Accounting Office report found that 44% of the penalties that IRS agents assessed under the payroll tax rules were wrong. The payroll tax rules are so complex that one-third of all U.S. employers are assessed penalties each year.⁷⁴ But complexity is not limited to the payroll tax rules. Many other areas of the tax code are also overly complex. The IRS assessed 29 million penalties in 1990, many of which were later abated.⁷⁵ Complex systems require vast armies of accountants and bookkeepers whose services could otherwise be freed up for more productive uses.

70. James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7 (1989).

71. The Internal Revenue Code is compiled in Title 26 of the United States Code.

72. Taxpayers who want to take their case to court have three choices. They can take their case to federal district court, the Claims Court, or the Tax Court. If they don't like the decision there, they can appeal to the federal appellate court, and again to the United States Supreme Court. Which route they choose depends on a number of often complex factors, which is complicated by the fact that the three court systems sometimes take different positions on similar or identical tax issues. And different federal district courts may also take conflicting positions on a tax issue, as may the Tax Court, in some circumstances.

73. D.W. Ball, *Retroactive Application of Treasury Rules and Regulations*, 17 N. MEX. L. REV. 139 (1987); J.S. Bryant, *Retroactive Taxation: A Constitutional Analysis of the Minimum Tax on IDCs*, 36 OKLA. L. REV. 107 (1983); Brian T. Camp, *The Retroactivity of Treasury Regulations: Paths To Finding Abuse of Discretion*, 7 VA. TAX. REV. 509 (1988); T. Robinson, *Retroactivity: The Case for Better Regulation of Federal Tax Regulators*, 48 OHIO ST. L. J. 773 (1987); *To What Extent Can Taxpayers Rely on IRS Regulations and Rulings to Predict Future IRS Conduct?*, 25 GONZAGA L. REV. 281 (1989/90).

74. Payne, *supra* note 67, at 21. There are a number of complexities in the U.S. tax system. For a discussion of these complexities, see JAMES L. PAYNE, *COSTLY RETURNS: THE BURDENS OF THE U.S. TAX SYSTEM* (1993).

75. Payne, *supra* note 67, at 21-22.

Emerging economies must be very careful that they do not fall into this quagmire of complex and uncertain regulations. Any tax system adopted should have built-in safeguards that protect against unnecessary complexity. The Swiss method might be used as an example. In Switzerland, the number of words that can be used is limited. Emerging economies must also guard against a proliferation of rules and regulations. It would not be too difficult to construct a tax code that is less than ten pages in length. And there is no need to have three different and often contradictory court systems to settle tax cases. Furthermore, to reduce the amount of unfairness in the system and increase the predictability, any tax system that is adopted should have a provision that makes regulations prospective only.

9. Clarity

Laws and regulations can be written either in clear, easy to understand language, or in extremely vague and obscure language. If laws are too vague and indecipherable, a court may rule that the law is void for vagueness.⁷⁶ But in other cases, the law may be held valid even though it has a high degree of vagueness or obscurity. Laws that are clear should be preferred to vaguely written ones. While this conclusion might seem obvious, in practice, the laws are often vague. This is especially true in the area of taxation.

A good illustration of this point is the survey that *Money* magazine does every year. For six tax seasons in a row since 1987,⁷⁷ *Money* asked 50 professional tax preparers to complete a federal tax return for a hypothetical family. Every year, all or nearly all of the tax practitioners have come up with the wrong answers. For its 1988 study, all 50 tax preparers got different answers to the same fact situation.⁷⁸ Their answers ranged from a tax liability of \$7,202 to \$11,881,⁷⁹ a variance of about 65%. *Money* conducted a similar test of 50 different tax practitioners in 1989 and got an even worse response.⁸⁰ Again, it got 50 different answers, but this time the answers ranged from \$12,539 to \$35,813. The 1990 study was somewhat better. Two of the fifty practitioners computed the right answer.⁸¹ Well, not quite. The 50 practitioners had 50 different an-

76. For discussion of what distinguishes a merely obscure law from one that is void for vagueness, see Note, *Due Process Requirements of Definiteness in Statutes*, 62 HARV. L. REV. 77ff. (1948); Note, *The Lawson Decision: A Broadening of the Vagueness Doctrine*, 13 STETSON L. REV. 412 ff. (1984); Note, *Recent Development, Void-for-Vagueness—Judicial Responses to Allegedly Vague Statutes*, 56 WASH. L. REV. 131ff. (1980).

77. Each year, American taxpayers must fill out a tax return that discloses information regarding their income and deductible expenses. They must compute their taxable income and tax liability. Often, they must hire a tax professional to do their tax return for them because the rules are so complicated. The tax season generally runs from about February 1 to April 15, which is when the tax return must be filed with the Internal Revenue Service, unless the taxpayer gets an extension of time.

78. Greg Anrig, Jr., *Even Seasoned Pros Are Confused This Year*, MONEY, Mar. 1988, at 134.

79. *Id.* at 135.

80. Greg Anrig, Jr., *The Pros Flunk Our New Tax-Return Test*, MONEY, Mar. 1989, at 110.

81. Denise M. Topolnicki, *The Pros Flub Our Third Annual Tax-Return Test*, MONEY, Mar. 1990, at 90.

swers again, but this time, the *Money* judges decided that 2 of the practitioners were close enough to the correct answer to be considered error-free. The practitioners computed tax liabilities ranging from \$9,806 to \$21,216, with an average of \$13,915. The correct answer was \$12,038, which was about half of what some practitioners calculated was owed.

The comedy of errors continued for the next two *Money* surveys. In the 1991 survey,⁸² one practitioner actually got the correct answer, which was \$16,786. The incorrect responses ranged from a low of \$6,807 to a high of \$73,247, which is quite a spread. In the 1992 survey, none of the practitioners got the correct answer,⁸³ although it was perhaps the most experienced group of the five groups that took the *Money* test over the past five years since, for the first time, *Money* instituted a minimum experience requirement of five years.⁸⁴ Answers ranged from \$16,219 to \$46,564. The correct response was \$26,619.

Another interesting fact that the *Money* surveys uncovered was that there was little or no relationship between the fees the practitioners charged and the quality of performance. The amount of fees charged and time spent varied widely. For the 1990 survey, for example, the practitioners charged between \$271 and \$4,000 to prepare the return, and spent anywhere from 4.5 hours to over 50 hours to complete it.⁸⁵ For the 1992 survey, practitioners charged between \$520 and \$4,500 and worked between 8 and 70 hours to complete the return.⁸⁶

Furthermore, IRS employees do not seem to do much better than the practitioners.⁸⁷ A General Accounting Office study of the IRS telephone assistance program conducted in 1987 found that IRS employees gave taxpayers the wrong answers 21% of the time.⁸⁸ In a similar survey by *Money* that used easier questions than the GAO survey, the IRS employees provided only 55% correct responses.⁸⁹ Another *Money* test conducted the following year found that IRS employees gave the correct answer only 59% of the time.⁹⁰ The IRS correct response rate improved somewhat in the next *Money* survey, which found that IRS was answering correctly 72% of the time.⁹¹ The *Money* survey conducted

82. Teresa Tritch & Deborah Lohse, *The Pros Flub Our Tax Test (Again!)*, MONEY, Mar. 1991, at 90.

83. Teresa Tritch & Deborah Lohse, *Tax Payers, Start Worrying!*, MONEY, Mar. 1992, at 88.

84. *Id.* at 89.

85. MONEY, *supra* note 82, at 90.

86. MONEY, *supra* note 84, at 89.

87. Actually, they may be much worse. The IRS employees were asked only a few questions each, whereas the practitioners had to determine the answers to many questions in the process of finishing the tax return. Even if every practitioner was able to come up with the correct answer 95% of the time, they would still make at least one error on the return if it involved making more than 19 decisions.

88. *So How Come the IRS Knows All the Answers When You Get Audited?* MONEY, Mar. 1988, at 136.

89. *Id.*

90. G.A. Jr. & Sylvia Steinhart, *Meet Your Friendly IRS Helper—If You Dare*, MONEY, Mar. 1989, at 112.

91. Denise M. Topolnicki, with Andrea Coccia & Deborah Lohse, *Surprise! The IRS Gets More Helpful*, MONEY, Mar. 1990, at 97.

the following year found that an astonishing 91% of the questions IRS employees answered were correct.⁹² The increase in correct responses was attributed to better training of the IRS personnel assigned to answer taxpayer inquiries. The 1992 survey found that IRS employees made correct responses 86% of the time.⁹³

If tax practitioners and IRS employees cannot get the right answers to common tax problems, how can regular taxpayers expect to do any better? Such needless complication in the tax system leads to noncompliance and a lack of respect for the system and the government. The complication is almost totally unnecessary. A much simpler tax system could be devised that would collect the same amount of revenue. The decisionmakers in emerging economies should resist adding complexity to their tax codes at every opportunity. Otherwise, after a number of years, their tax system will be as complicated as the US one.

10. Rules Should Not Change Frequently

Governments may enact tax rules that remain on the books for decades or they may make rules that change constantly. While it is always a good idea to change a law that is bad or to improve a law where possible, many times governments go beyond mere improvement and engage in fine tuning. In the United States, for example, Congress has enacted major changes in the tax laws practically every year since 1981. Few tax practitioners would argue that the changes have made the tax law better or easier to comprehend. The tax rules have, in many cases, become more complex and obscure over time. Furthermore, constant changes—sometimes retroactive changes—have made it difficult for tax payers, such as businesses, to plan. Business decisions are often influenced by the tax laws. When the laws change frequently, businesses must make their plans with a higher degree of uncertainty.

Frequent changes also increase compliance costs. Tax practitioners and business owners must spend time and money to learn the new rules. Businesses must also adjust their practices to comply with new rules. The cost of complying with the tax legislation that was enacted in 1987 was estimated to be \$6.2 billion for 1988 alone.⁹⁴ The cost of complying with the 1989 tax law changes was estimated to be \$0.1 billion for 1989 and \$5.6 billion for 1990.⁹⁵ Compliance costs for the 1990 Budget Accord were estimated to be \$23.2 billion in 1991 and \$10 billion in 1992.⁹⁶ Compliance costs must be taken into account when a government considers enacting a new piece of tax legislation.

92. Miriam A. Leuchter, with Judy Feldman and Lisa Fickensher, *The IRS Aces This Year's Money Telephone Exam*, MONEY, Mar. 1991, at 100.

93. Deborah Lohse, *IRS Staffers Still Flub More Than One Question Out of 10*, MONEY, Mar. 1992, at 92.

94. Robert Genetski, *The True Cost of Government*, WALL ST. J., Feb. 19, 1992, at A14.

95. *Id.*

96. *Id.*

Another problem with frequent changes in the tax laws that has an especially devastating effect on newly emerging economies is the effect on foreign investment. Trying to convince foreign investors to invest in a new, unproven country is difficult enough without making investment returns even more uncertain by frequent changes in the tax laws. Russia is only one of several examples that illustrate the point. The tax situation in Russia is changing so rapidly that not even Russian government officials always know what the tax laws are or how they should be applied.

11. Effects on Behavior and Incentives

The effect that a tax provision will have on behavior and incentives is another factor that should be considered when constructing any tax scheme. If an individual tax rate is close to 100%, it is reasonable to expect that marginal income will not expand and may even decrease. People will tend to work less overtime and not seek out second, part-time jobs. People will tend to spend their money rather than save and invest it. Investors will seek investments in a country with lower tax rates. If there is a perception that individuals are not able to keep the fruits of their labor, then they will produce less fruit. Additionally, if the tax is perceived to be unfair, individuals will have more of a tendency to evade the tax.

Ideally, from a tax collector's perspective, a tax should have both high rates and no negative effect on incentives or behavior. But such a tax exists only in a dream world. There is an inverse relationship between the tax rate and the incentive taxpayers have to create wealth. This relationship must be taken into account when decisionmakers are constructing or altering their tax system. If the goal is to increase wealth, then decisionmakers should reduce taxes. If the goal is to increase revenue, then perhaps (but not necessarily) rates should be raised. However, in the real world, government planners usually want to raise more revenue and increase wealth at the same time. Thus, some tradeoffs must be made between raising revenue and economic growth. Based on present rates and past experience, it seems that policymakers should prefer higher economic growth and lower tax rates.

12. Effects on Social Harmony

The effect that a particular tax law will have on social harmony should be taken into account. Some tax laws, like the poll tax in England, anger the general populace. Other tax laws, like the graduated income tax, pit one class against another—in this case, high income earners against the low income earners. A graduated income tax is divisive because it forces high income earners to pay what might be perceived to be more than their "fair share." Also, it exacerbates the envy that the lower income earners already have toward high income

earners.⁹⁷ The graduated income tax is based on the ability-to-pay principle rather than on the cost benefit principle. Like all such tax measures, this causes resentment since those who must pay more feel that they are being exploited by those who must bear less of the burden.

Another example of a tax policy that reduces social harmony is the current pension law in the United States. The pension law is so complex and the penalties so potentially burdensome and threatening that many employers have terminated their pension plans rather than comply. This decision has adversely affected hundreds of thousands of employees over the years, many of whom need coverage.

In the area of defined benefit pension plan terminations alone, the effect of the law has been devastating. During the early 1980s, between 4,000 to 5,000 employers were terminating their plans each year. By 1985 the number had increased to more than 12,000 and by 1989 the number of plans terminated annually had jumped to more than 16,000.⁹⁸ Recent evidence indicates that the situation may be getting worse.⁹⁹ Between October, 1991 and September, 1992, 19,390 employers filed termination application letters with the Internal Revenue Service. These termination applications would terminate various types of pension and profit sharing plans for 960,876 employees. Since Social Security will not provide these employees with much of a pension, they will have to find another way to provide for their retirement. Most of these employers are terminating their pension plans because the cost of compliance is too high and the risk of inadvertently running afoul of the many potential penalties is too great. Yet IRS and Treasury Department bureaucrats continue to write pension laws and regulations that have the opposite effect of what was intended when Congress enacted the Employee Retirement Income Security Act of 1974 (ERISA), namely, to provide security for employees.

Emerging economies should ensure that the tax laws they enact do not have a similar effect. Good intentions are not enough. The result of a well-intentioned tax policy can be devastating on a segment of the population or on the economy in general. Furthermore, it is not always easy to reverse a bad tax policy as is seen by the case of the ERISA law in the United States. Policymakers refuse to admit that they have made a mistake. Rather than repeal the law, they make constant attempts to amend it. This only aggravates the situation.

Another social harmony factor that should be considered by those who make tax policy is the effect a particular policy will have on employment. Some tax increases raise the administrative burden of business. This is harmful because productivity can be reduced if private sector employees must administer a

97. For more on this point, see HELMUT SCHOECK, *ENVY: A THEORY OF SOCIAL BEHAVIOR* 194, 217, 221 (1966); ROBERT SHEAFFER, *RESENTMENT AGAINST ACHIEVEMENT: UNDERSTANDING THE ASSAULT UPON ABILITY* 177, 186 (1988).

98. *RESULTS OF THE AMERICAN ACADEMY OF ACTUARIES SURVEY OF DEFINED BENEFIT PLAN TERMINATIONS* (Am. Acad. of Actuaries Prelim. Rep., 1992).

99. *Internal Revenue Service Statistics on Employee Plan Determination Letters*, Oct. 1991—Sep. 1992, *DAILY TAX REP.* (BNA) L-1 (Nov. 19, 1992).

tax law rather than engage in some activity that produces wealth. In the state of Colorado, for example, one study found that a 1% increase in the state sales tax would destroy as many as 75,000 jobs.¹⁰⁰ Another study estimated that 72,000 jobs were lost because of a change in the law requiring restaurants to collect and report the income of employees for Social Security purposes.¹⁰¹

Another factor that can reduce social harmony is inappropriate methods of tax collection. In the United States, the Internal Revenue Service conducts more than one million audits of income tax returns each year.¹⁰² While many of the audits the IRS conducts are low-key, polite, and nonthreatening, such is not always the case. IRS agents sometimes resort to harassment, verbal abuse, and the improper confiscation of property.¹⁰³ In at least one case, IRS errors drove a taxpayer to suicide.¹⁰⁴ His wife then used the life insurance proceeds to beat the IRS in court.¹⁰⁵ In many other cases, the IRS resorts to illegal methods to collect taxes that are not owed.¹⁰⁶ Property is confiscated without a court order and sold for a fraction of its worth, taxpayers are sometimes assaulted and battered, witnesses are harassed and threatened, all in the name of tax collection.¹⁰⁷ This kind of abuse by government reduces social harmony and exacerbates the tension that exists between the government and the people.

A good tax collection system will incorporate safeguards that minimize the possibility that government bureaucrats will abuse their power. At the very least, government officials should not be able to confiscate property until after some legitimate court has declared that the tax is owed. This is not the case in the United States, where the IRS can confiscate property without a court order and without a hearing of any kind. Moreover, the burden of proof should be on the government to prove that the tax is owed. At present, the burden is on the taxpayer to show that the tax is not owed. In cases where abuse has taken place, taxpayers should be able to receive compensation for their loss. At present, the amount of compensation they can receive is limited to reimbursement of some court costs, and even then, recovery is not certain. If the government seizes property worth \$10,000 and sells it for \$1,000, the taxpayer's recovery is limited to \$1,000 if it turns out that the tax was not owed in the first place.¹⁰⁸ Additionally, IRS employees are immune from prosecution; they can assault and batter taxpayers, confiscate their assets without a court order, harass witnesses and

100. The study was conducted by The Independence Institute of Golden, Colorado, reported in DAILY TAX REP. (BNA) H-2 (Oct. 9, 1992).

101. The study was conducted by the Employee Policies Institute, reported in DAILY TAX REP. (BNA) H-2 (Mar. 9, 1992).

102. Payne, *supra* note 67, at 21.

103. See GEORGE HANSEN, TO HARASS OUR PEOPLE: THE IRS AND GOVERNMENT ABUSE OF POWER (1984). See also DAVID BURNHAM, A LAW UNTO ITSELF: POWER, POLITICS AND THE IRS (1989).

104. *Id.*

105. Payne, *supra* note 67, at 21.

106. One member of Congress wrote a book that documents some of the many IRS abuses. HANSEN, *supra* note 103; see also BURNHAM, *supra* note 103.

107. *Id.*

108. *Id.*

force them to change their testimony, all without fear of personal consequences.¹⁰⁹ A tax system that is constructed on the basis of equity and fairness would provide safeguards against such abuses.¹¹⁰

13. Administrative Costs

A tax system can be structured so that administrative costs are low or quite high. In measuring the administrative cost of a particular tax policy or of a tax system as a whole, the administrative costs to government are not the only costs that should be considered. The cost to the taxpaying community must also be taken into account.¹¹¹ In the United States, for example, the cost of administering the tax law falls more than 99% on the private sector. The budgets of the Internal Revenue Service and the parts of the Treasury and Justice Departments that administer the tax laws was about \$6 billion in 1990. The costs of administration that fell to the private sector for the same period were estimated to be \$618 billion,¹¹² which represents about 65% of the tax collected.

A study by Arthur D. Little,¹¹³ a consulting firm, estimated that it took businesses and individuals 3.614 billion hours and 1.813 billion hours, respectively, to comply with federal tax rules in 1985. When this combined total, 5.427 billion hours, is translated into whole persons, the statistic takes on more meaning. If the average work-year per employee is 1,844 hours, then it would take 2.943 million people, working full-time, just to comply with the federal tax laws (state compliance costs are extra). That means practically every man, woman and child in a city the size of Chicago—the United States' third largest city—would have to work full-time to comply with the United States' federal tax laws.¹¹⁴ If these individuals charged an average cost of \$28.31 per hour, which was the average of the wage cost for Arthur Andersen employees (\$35.47) and IRS employees (\$21.14) in 1985,¹¹⁵ then the cost of complying with the federal tax laws in 1985 would have been almost \$159.4 billion, which is about the gross national product of Belgium.¹¹⁶ This figure excludes the cost of hiring professional assistance, which in 1985 would have added another \$5.8

109. *Id.*

110. *Id.* It should be pointed out that many of the abuses IRS now gets away with could be eliminated by abolishing the individual income tax, or replacing the present, complicated tax with a flat-rate tax.

111. Joel Slemrod & Nikki Sorum, *The Compliance Cost of the U.S. Individual Income Tax System*, NAT'L TAX J., Winter 1984, at 461.

112. Payne, *supra* note 67, at 18.

113. This study is summarized *id.* at 19.

114. The population of Chicago in 1988 was 2,977,520, according to THE WORLD ALMANAC AND BOOK OF FACTS 1991, at 557 (1990).

115. See *supra* note 113.

116. THE WORLD ALMANAC AND BOOK OF FACTS 1991, at 690 (1990), lists Belgium's 1988 gross national product at \$153 billion. Note that the estimated \$154 billion in compliance cost is in 1985 dollars. If 1988 dollars were used instead, this figure would be slightly higher. This cost also does not include the cost of complying with state and local tax laws.

billion to the cost. This, combined with the \$159.4 billion figure, amounts to 24.43% of the tax revenues collected.¹¹⁷

A number of other studies have also estimated the costs that taxpayers incur in complying with various portions of the U.S. tax law. One pension actuary estimated that the cost to employers of complying with just the employee benefit provisions of the Unemployment Compensation Amendments Act of 1992¹¹⁸ might exceed \$4 billion over the first five years, which is more than twice the amount of revenue that is expected to be raised from the law.¹¹⁹ He estimated that the cost of compliance for a benefit plan would be about \$1,500, and the annual administrative costs would be about \$1,000 per plan just to fill out the paperwork and to comply with the law's requirements. Since there are about 600,000 defined contribution plans and 100,000 defined benefit plans that fall within the ambit of this law, the total start-up cost of complying would be about \$1.05 billion, and the annual administration cost would be \$700 million, which amounts to \$4.55 billion over the first five years. The government expects to raise about \$2.147 billion in revenue over the same period of time. And even this revenue estimate might be optimistic. Small employers, who are the least able to pay such costs, might decide to terminate their plans rather than incur the high compliance cost.

It has been estimated that the cost to employers for complying with the payroll tax rules in the United States was more than \$59 billion for the five-year period ending in 1992.¹²⁰ Another study estimated that it took 2 billion taxpayer hours plus \$3 billion in professional assistance to fill out federal and state income tax returns in 1982.¹²¹ Tax law changes since that time, plus inflation, would push the cost of compliance to over \$30 billion annually, assuming the average taxpayer expends time that is worth \$12 or \$15 an hour.¹²² A General Accounting Office study estimated that it took 1.815 billion hours for taxpayers to complete the necessary tax return paperwork for fiscal year 1988, although that estimate may be low.¹²³ A U.S. Office of Management and Budget report

117. Payne, *supra* note 67, at 20.

118. Pub. L. No. 102-318.

119. *Withholding, Direct Transfer Amendments Seen Costing Employers Over \$4 Billion*, DAILY TAX REP. (BNA) G-4 (Aug. 4, 1992).

120. Robert Genetski, *The True Cost of Government*, WALL ST. J., Feb. 19, 1992, at A14.

121. Joel Slemrod & Nikki Sorum, *The Compliance Cost of the U.S. Individual Income Tax System*, NAT'L TAX J., Winter 1984, at 461-474.

122. This estimate is conservative for several reasons. For one thing, the more an individual makes, the more time he is likely to spend preparing a tax return, so the \$12 to \$15 hourly estimate is a bit low. And there are many million more taxpayers now than there were in 1982, so the total number of taxpayer hours required to file tax returns is probably much more than 2 billion now. And the tax laws have become more complicated since 1982, so taxpayers probably spend more time in preparation now than then, and probably spend more for professional assistance, too.

123. U.S. GENERAL ACCOUNTING OFFICE, *PAPERWORK REDUCTION: LITTLE REAL BURDEN CHANGE IN RECENT YEARS* GAO/PEMD-89-19FS (1989).

estimated that the Treasury Department spent 4.27 billion hours in respondent time collecting information in fiscal year 1989.¹²⁴

Another factor that must be considered is the cost of administration from the government's perspective. In the United States, for example, a tax that is collected locally, such as a property tax, can be used almost completely to pay for services. Perhaps only 5%-15% of what is collected is spent on administration. For taxes collected at the state level, the percentage of collections used in administration is somewhat higher, perhaps 20%-30%. Taxes collected at the federal level sometimes involve an even higher administration cost. For some federal programs, the amount spent on administration far exceeds the amount that is available to the population intended to be served. The farther the geographic distance between the collector and the proceeds' recipient, the greater the administrative charge.

Tax policymakers should consider the deadweight loss that a particular tax policy will generate. Because of the administrative charge, there will always be some gap between the funds that are collected and the amount that is available for spending on programs. Funds can be used most efficiently where this deadweight loss is minimized.

Furthermore, in the United States there is some resentment because citizens of the individual states do not feel that they are getting their moneys' worth from federal government services. They perceive that they pay more money than what they get back in benefits. There is some truth to this perception. New York Senator Daniel Moynihan states that New York State residents paid \$838 more, per capita, to the federal government than what they received back in benefits. Over a recent 15 year period, Moynihan reports that New Yorkers have been "cheated" out of \$136 billion.¹²⁵

14. *Costs and Benefits*

Another factor to consider when constructing a tax scheme is the relative cost and benefit. The tax collected should exceed the cost of administration. But the cost-benefit comparison should not be limited to just easily traceable, tax-related administrative costs, because the cost of administering a tax system sends ripple effects throughout the economy. These indirect, ripple-effect costs should also be considered.¹²⁶

The tax law should also result in a net increase in tax being collected. While this seems obvious and hardly worthy of mention, the luxury tax rules in

124. U.S. OFFICE OF MANAGEMENT AND BUDGET, REPORT TO THE CONGRESS: FEDERAL PROCUREMENT PAPERWORK BURDEN (1990), cited in THOMAS D. HOPKINS, COST OF REGULATION (Rochester Inst. of Tech. Pub. Pol'y Working Paper, 1991).

125. *Taxes Paid Versus Federal Funds Received*, DAILY TAX REP. (BNA) H-4 (Aug. 7, 1992). These statistics are based on the 16th annual edition of New York State and the Federal Fisc, WHO CHEATED NY OF \$136 BILLION?, published in association with the Taubman Center for State and Local Government, John F. Kennedy School of Government, Harvard University.

126. MURRAY L. WEIDENBAUM & ROBERT DEFINA, THE COST OF FEDERAL REGULATION OF ECONOMIC ACTIVITY (Am. Enterprise Inst. ed., 1978).

the United States provide an example¹²⁷ of where this is not the case.¹²⁸ A few years ago, the tax code placed an excise tax on “luxury” automobiles—automobiles that cost more than \$30,000.¹²⁹ Since this rule took effect, auto dealers selling high priced cars have been complaining because people are not buying their cars anymore. They are selling fewer cars, their profit margins have shrunk, and some auto dealers have gone out of business. Some of the employees who were employed by these dealers are no longer paying taxes but may be collecting unemployment insurance or welfare. The auto dealers are paying less taxes because they make less profit. The amount of taxes lost by this rule has exceeded the amount of tax the government would collect from the rule.¹³⁰ Nevertheless, Congress has not yet repealed the tax because of inertia.

The same is true for excise taxes imposed on boats, airplanes, jewelry and furs. Many boat manufacturers have been driven out of business by the excise tax, as have a few small airplane manufacturers. Rather than raise tax revenues, the imposition of these excise taxes has reduced total tax revenues because the small amounts collected have been more than offset by the lower amounts of income taxes that have been collected. Yet these taxes were not repealed immediately because many members of Congress perceive that repealing luxury and excise taxes would appear to be coddling the rich. In fact, they are destroying working class jobs.

Two taxes that raise the most revenue for most Western governments (aside from social security taxes) are the income tax and the value added tax. The next two parts of this paper will examine these two forms of taxation.¹³¹ The income tax system of the United States was chosen for analysis because the author is most familiar with that income tax system. The value-added tax will be evaluated from a variety of perspectives. Emphasis will be placed on the theory and practice of value-added taxation in general. Examples will be based primarily on the European experience, since the United States does not have a value-added tax.

127. The law under discussion is the Omnibus Budget Reconciliation Act of 1990, which took effect January 1, 1991.

128. Some of the effects of this law are examined in U.S. GENERAL ACCOUNTING OFFICE, TAX POLICY AND ADMINISTRATION: LUXURY EXCISE TAX ISSUES AND ESTIMATED EFFECTS GAO/GGD-92-9 (1992).

129. It should be pointed out that this law also acts as a protectionist tool to keep out foreign-made autos, since many of the cars that cost more than \$30,000 are imported into the United States.

130. The law has probably had negative effects on health, too. Since luxury cars tend to be big cars, and since increasing the luxury tax will cause some consumers to substitute smaller, less safe cars for larger cars, it might be that the number of fatal accidents has increased as a result of the luxury tax, since large cars are better able to withstand impact in an accident than are smaller cars. The number of auto fatalities caused by the luxury tax on autos is difficult to estimate, but would be a good topic for further research.

131. The next section is not limited to a discussion of the income tax, but the income tax will be the main topic for discussion.

III.
 THE INCOME TAX: LESSONS FROM THE U.S. EXPERIENCE

A. *Overview*

The income tax is one of the major sources of revenue in the United States. However, it is misleading to speak in terms of “the” income tax because there are really several income taxes. At the federal level there is the individual income tax and the corporate income tax. Most of the 50 states also have an individual and corporate income tax. Some cities also have an individual and/or corporate income tax, which may (or may not) be incorporated into the state income tax. The breakdown of tax sources and expenditures in the United States is as follows:

Tax Sources — Federal ¹³²	
Individual income tax	45%
Payroll taxes	37
Corporate income taxes	9
Excise taxes	3
Customs duties	2
Estate and gift taxes	1
Other	3
Tax Expenditures — Federal ¹³³	
Income security	39%
National defense	24
Interest on public debt	15
Commerce, housing and transportation	8
Education, training and health	8
Agriculture, natural resources and environment	4
Other	3

The approach listed above is not the only way that could be used to illustrate federal government income sources and expenditures. For example, in the case of the federal government a substantial portion of the annual budget comes from financing the deficit. If this fact were taken into account, the figures would be as follows:

132. ECONOMIC REPORT OF THE PRESIDENT, *cited in* McCONNELL & BRUE, *supra* note 35, at 98. The figures are for 1990.

133. *Id.*

Tax Sources — Federal ¹³⁴	
Individual income taxes	35%
Social security, medicare, and unemployment and other retirement taxes	30
Borrowing to cover the deficit	21
Corporate income taxes	7
Excise, customs, estate, gift and miscellaneous taxes	7
Tax Expenditures — Federal ¹³⁵	
Social security, medicare and other retirement	33%
National defense, veterans, and foreign affairs	24
Net interest on the debt	14
Physical, human and community development	10
Social programs	17
Law enforcement and general government	2

The figures for state and local governments are as follows:

Tax Sources — State ¹³⁶	
Sales, excise and gross receipts taxes	49%
Individual income taxes	32
Corporate income taxes	7
Property taxes	2
Death and gift taxes	1
Licenses, permits and other	8
Tax Expenditures — State ¹³⁷	
Public welfare	25
Education	23
Highways	13
Health and hospitals	13
Public safety	9
Other	18
Tax Sources — Local Governments ¹³⁸	
Property taxes	75
Sales and excises	15
Individual and corporate income taxes	6
Licenses, permits and other	4
Tax Expenditures — Local Governments ¹³⁹	
Education	43
Welfare, health and hospitals	13
Environment and housing	11
Public safety	10
Transportation	7
Other	16

134. INTERNAL REVENUE SERVICE, 1993 1040 FORMS AND INSTRUCTIONS, back cover. The figures are for the fiscal year ended September 30, 1992.

135. *Id.*

136. BUREAU OF THE CENSUS, STATE GOVERNMENT FINANCES IN 1990, *cited in* MCCONNELL & BRUE, *supra* note 35, at 100.

137. *Id.*

138. *Id.*

139. *Id.*

B. The Individual Income Tax

Emerging economies are adopting the income tax as one of the major means of raising revenue. Unfortunately, they are incorporating the undesirable features of the tax as well as the less harmful aspects. Hungary, for example, introduced a personal income tax in 1988 that had rates ranging from 20-60% with 21 brackets. The following year it reduced the rates to 17-56% and the number of brackets to eight. In 1990, it dropped the top rate to 50%.¹⁴⁰ Even Portugal, a western country, adopted a personal income tax that incorporates some of the complex features of the U.S. system such as differential rates, separating income into different categories, and providing special treatment for certain categories of income or taxpayer.¹⁴¹

The individual income tax is one of the major forms of taxation in most western democracies.¹⁴² Generally, any tax on individual income is "bad" in that it dampens incentives¹⁴³ to produce and takes property without the owner's consent. The individual income tax also causes economic distortions, because it causes resources to shift as part of the redistribution process.

If one must have an individual income tax,¹⁴⁴ there are a number of options to choose from. Some income tax systems are worse than others. Systems with high rates will dampen incentive more than systems with low rates. As incentives are dampened, economic growth is stifled. Studies of the individual income tax system in the United States have estimated that for every \$1 of individual income taxes raised, between \$0.24 and \$0.47 is lost in production.¹⁴⁵

A system based on the cost-benefit principle is more equitable than one based on the ability to pay principle. A system based on the cost-benefit approach attempts to employ some form of rough justice, whereas an ability to pay system is based on exploitation. A system with uniform rates is more equitable and simpler than one with graduated rates. Interestingly, Karl Marx advocated a heavy, progressive income tax as a way to destroy capitalism.¹⁴⁶ This fact should be kept in mind when constructing a tax system that includes an income tax.

140. V. Tanzi, *Tax Reform and the Move to a Market Economy: Overview of the Issues* [hereinafter *Tax Reform*], in *THE ROLE OF TAX REFORM IN CENTRAL AND EASTERN EUROPEAN ECONOMIES* 19, 25 (OECD ed., 1991) [hereinafter *THE ROLE OF TAX REFORM*].

141. M. Alexandre, *The Move to a Global Income Tax System in Portugal*, in *THE ROLE OF TAX REFORM IN CENTRAL AND EASTERN EUROPEAN ECONOMIES* 57 (OECD ed., 1991).

142. For a summary of the tax systems for more than 100 countries, see COOPERS & LYBRAND, *1994 INTERNATIONAL TAX SUMMARIES: A GUIDE FOR PLANNING AND DECISIONS* (1994).

143. Russell Shannon, *Incentives and Income Taxes*, *FREEMAN* 653-656 (1981).

144. Some commentators have advocated replacing the income tax with a value added or consumption tax. Both of these alternatives will be discussed in text below.

145. A 1981 study by Jerry Hausman estimated the loss to be \$0.287. A 1984 study by Charles Stuart estimated the loss to be \$0.244. A 1987 study by Edgar Browning estimated the cost to be \$0.318 and \$0.469. These studies were mentioned in Payne, *supra* note 67, at 20.

146. KARL MARX, *THE COMMUNIST MANIFESTO* (1848).

There are a number of other problems with the concept of a progressive income tax.¹⁴⁷ Some theorists have advocated a progressive income tax as a way to equalize utilities between and among individuals. However, as Hayek¹⁴⁸ and others¹⁴⁹ have pointed out, there is no way to objectively compare the utilities of different individuals. And, even if it were possible, it is questionable whether equalizing utilities is a legitimate goal or function of government. Isn't the goal of government to provide services to its citizens? Is it ethical to take a portion of someone's property just because they have more than someone else? Does it make any difference whether the taker is a single individual or a government? Yet redistribution is the concept upon which the progressive income tax is based, a concept that some writers regard as unethical.¹⁵⁰ Progressive taxation is also an abuse of the concept of majority rule because the majority (lower and middle income people) are forcing a minority (upper income individuals) to pay more for government than what they receive in benefits. The majority is forcing a minority to pay for some of the majority's benefits.

Applying the theory of decreasing marginal utility to income taxation demonstrates that those who advocate progressive rates on marginal utility grounds are standing on a shaky theoretical foundation. According to the theory of decreasing marginal utility, it takes more to stimulate a rich man to produce than it does to stimulate a poor man. If the goal is to stimulate production and create wealth, the rich rather than the poor should be stimulated by giving them lower tax rates since the rich produce more than the poor. Thus, applying the marginal utility theory to taxation supports the conclusion that tax rates should be regressive rather than progressive.¹⁵¹

The effect of an income tax system on capital accumulation must also be considered. If rich people save and invest more than middle and lower income people and if the goal is to increase saving and investment,¹⁵² and thus economic growth, then the tax system should encourage (or at least not discourage) capital accumulation. While any form of income taxation has a negative effect on capital accumulation, progressive taxation has a more adverse effect than a

147. The classic study is by BLUM & KALVEN, *supra* note 44.

148. Hayek, *supra* note 44, at 229.

149. ROTHBARD, *supra* note 7, at 260-68; C. Welch, *Utilitarianism, in THE NEW PALGRAVE: THE INVISIBLE HAND* 257, 266-67 (John Eatwell et al. eds., 1989). Another view of the marginal utility theory is that the rich should be taxed at higher rates because they do not get as much satisfaction from their last dollar as the poor. In other words, a dollar to a millionaire is nothing, but a dollar to a poor man may be a fortune. Thus, the argument goes, the rich should be taxed perhaps a dollar or more, while the poor should pay only a dime. One problem with this line of reasoning is that it is impossible to measure interpersonal utilities. Another problem is that governments should treat all citizens equally, and this approach—graduated tax rates—violates that basic principle. Rothbard, *supra* note 7, at 260-68, addresses this issue in depth.

150. For perhaps the most thorough treatise on this point, see DE JOUVENEL, *supra* note 6.

151. I am not advocating a regressive tax system, I am merely making my point about the views of those who advocate progressive rates on marginal utility grounds.

152. It is questionable whether encouraging people to invest rather than consume is a legitimate function of government, since it is really no business of government telling people what they should do with their money.

flat tax because a progressive tax takes more money from the segment of the population that is more likely and able to invest.

If a government must resort to an income tax, a flat-rate tax at least avoids some problems inherent in a progressive tax system.¹⁵³ Compared to a progressive tax, a flat tax is also more equitable because it is based, more than a progressive tax, on the cost-benefit principle rather than the ability-to-pay principle. A major advantage of a flat tax lies in its potential simplicity. Much of the complexity of the U.S. tax code is due to the progressive system which attempts to affect behavior by granting deductions and tax credits for a plethora of activities. However, those in a flat rate world would still seek deductions *ad infinitum* and seek to make everything an expense. A head tax would cure the problem. A simple flat tax would eliminate the need for perhaps 99% of the U.S. tax code¹⁵⁴ and eliminate the need for millions of taxpayers to hire professional assistance to compute their tax liability. Much of the effort now expended in the private sector to comply with the law, to keep the necessary records, and to do tax planning could then be freed up to do something more productive. The administrative costs saved by businesses could either be plowed back into the business or passed on to customers in the form of lower prices.

Another advantage of the flat tax is that it is more equitable horizontally. In other words, people who earn the same amount of income pay about the same amount in taxes. Under the present system in the United States, people who earn, say, \$50,000 in wages might pay more than someone who earns \$50,000 in long-term investment income. Someone who owns a home might pay less than someone who rents an apartment because of the incentives, deductions, and credits that are built into the system. A flat tax would also eliminate all of those differences by basing the tax on the amount of income earned, not the sources from which it came or what a taxpayer decides to do with disposable income. Thus, a flat tax would not cause as much distortion in the economy because tax incentives would not induce people to make decisions that result in the misallocation of resources solely to save taxes. A flat tax would eliminate "bracket creep," the tendency of taxpayers to go into higher tax brackets because of inflation,¹⁵⁵ because everyone would pay the same rate. A flat tax would also eliminate the "marriage" tax penalty since it would tax single individuals and married individuals at the same rates.¹⁵⁶

Another problem with any individual income tax, especially in emerging economies, is that it is difficult to collect. Even if a system is in place to collect

153. For a commentary that advocates a flat tax, see HALL & RABUSHKA, *supra* note 45.

154. The exact percentage of the tax code that could be eliminated by adopting a flat tax depends on what other changes Congress would make to the system. Eliminating excise, estate and gift taxes and the corporate income tax would be feasible under a flat tax system, but whether Congress would choose to do so is another question.

155. Paul Gary Wyckoff, *Flat Taxes and the Limits to Reform*, in *ECONOMIC COMMENTARY 2* (Federal Reserve Bank of Cleveland ed., 1984).

156. For a treatise on horizontal equity and the taxation of family units, see *TAXING THE FAMILY* (Rudolph G. Penner ed., 1983).

individual income taxes from the salaries and wages of workers, only the taxes of the workers in the official sector of the economy will be collected.¹⁵⁷ Those in the informal sector¹⁵⁸ will escape the tax. If one of the goals of tax policy is to have a wide tax base, the individual income tax might fall short of the goal if there is a large informal economy.

As was previously mentioned, the individual income tax system in the United States is highly complex. Any country that wants to raise revenue in an efficient manner should not emulate the complexity of the current U.S. system.

C. The Corporate Income Tax

Many of the above observations regarding the individual income tax apply equally to the corporate income tax. Nevertheless, there are some differences. Given that individuals can vote but corporations cannot, politicians encounter less resistance when they advocate raising the corporate tax than when they attempt to increase the individual income tax. However, ultimately, only individuals pay taxes.¹⁵⁹ Thus, the corporate tax functions as a hidden tax on individuals. In that sense, taxing corporations is dishonest.

Corporate income taxes are coercive rather than voluntary, and therefore constitute a less favored way of raising revenue. The corporate tax is based on the ability-to-pay principle rather than cost benefit, which also makes it a less desirable form of taxation. In the United States, the corporate income tax is progressive. Corporations that earn over a certain amount pay a higher percentage of their income in taxes.¹⁶⁰ Corporations that incur losses do not pay any income tax even though they may receive some government benefits. Since the government tends to be more of a hindrance than a help to business, most corporations paying taxes probably are not getting an equivalent payback in government services.

Furthermore, in the United States the double tax effect of corporate taxes seems unfair. For example, if a corporation has taxable income of \$100 and it pays 40% of its profits in taxes, it will have only \$60 left to reinvest or pay dividends. If it pays the \$60 as dividends to a shareholder who is in the 40% tax bracket, the individual will pay a \$24 tax, which leaves only \$36. The total tax will be \$64 (\$40 + \$24), or 64%, and the shareholder receives only \$36 after-

157. Richard M. Bird makes this point in *TAX POLICY & ECONOMIC DEVELOPMENT*, *supra* note 4, at 15.

158. The informal sector is the sector of the economy that the government cannot locate. Bureaucrats know that this sector exists but they cannot find it to tax it, and participants in the informal economy seldom, if ever, send in tax checks voluntarily.

159. If the corporation is able to pass on the tax in the form of higher prices, then the individuals who pay for the corporation's products or services ultimately pay the tax. If the tax cannot be passed on, then the individuals who own the corporation's stock have to settle for a lower rate of return on their investment, since the government siphons off a large chunk of the corporation's pretax profits. Either way, individuals ultimately pay the corporation's tax.

160. I.R.C. § 11 (1995); Treas. Reg. 1.11-1 (1995)

tax.¹⁶¹ Yet, the shareholder made the investment and took all the risk. The government merely skims two-thirds of the profit and does nothing to earn it. This is why some economists favor making dividends tax-free, since taxing dividends results in double taxation of the same income.¹⁶²

The U.S. corporate tax structure also makes administration difficult for the private sector. The largest corporations must retain the services of dozens, or even hundreds, of personnel to keep tax records and compute the corporation's tax liability. The IRS must employ thousands of individuals to administer the system.¹⁶³ Many fewer individuals would be employed both by the government and by the private sector if the rules were simpler and clearer.

Corporate income taxes detrimentally affect economic growth. Every dollar that is siphoned off in the form of taxes is not available for investment. The corporate tax makes American business less competitive in world markets. A Brookings Institution study conducted by Roger Gordon and Burton Malkiel in 1981 estimated that for each dollar raised by the corporate income tax the country lost \$1.39 in production.¹⁶⁴ A 1989 study by Jane Gravelle and Laurence Kotlikoff of the National Bureau of Economic Research estimated that production dropped by between \$0.84 and \$1.51 for each dollar of taxes raised.¹⁶⁵ One economist estimated that the value of the efficiency¹⁶⁶ lost by the corporate income tax may be as much as half of the revenue raised by the tax.¹⁶⁷

Corporate income taxes can also cause financial distortions, as they have in the United States.¹⁶⁸ The law favors noncorporate enterprises over corporations, encourages debt financing over equity financing, and favors retained earnings over dividend distributions.¹⁶⁹ Corporations can take a tax deduction for

161. At some times in U.S. history, the situation has been much worse. There have been times when the top corporate rate was more than 50% and the top individual rate was more than 90%. With rates as high as these, the high bracket shareholder who received a dividend actually got to keep about 5% of the corporation's pre-tax income.

162. Dividend income is tax-free in some western democracies, but not in the United States. For the specifics of how dividends are treated in more than 100 countries, see COOPERS & LYBRAND, *supra* note 142.

163. The IRS has more than 120,000 employees, some of whom are employed in the corporate tax area.

164. This study was cited by Payne, *supra* note 67, at 20.

165. *Id.* The study Payne referred to was JANE G. GRAVELLE & LAURENCE J. KOTLIKOFF, CORPORATE TAXATION AND THE EFFICIENCY GAINS OF THE 1986 TAX REFORM ACT (National Bureau of Econ. Res. Working Paper No. 3142, 1989).

166. The more efficient a business entity is, the more revenue it can generate. If it costs \$100 in efficiency losses to raise \$200 in taxes, then the value of the efficiency lost by the corporate income tax is equal to half the revenue raised by the tax.

167. J. GREGORY BALLENTINE, EQUITY, EFFICIENCY, AND THE U.S. CORPORATION INCOME TAX (1980).

168. Jeffrey J. Hallman & Joseph G. Haubrich, *Integrating Business and Personal Income Taxes*, in ECONOMIC COMMENTARY 2 (Federal Reserve Bank of Cleveland ed., 1992). These authors evaluated five proposals to reform the corporate tax system in order to reduce tax avoidance costs and financial distortions caused by the present corporate tax system.

169. Although this paper emphasizes the U.S. corporate tax, many of the same arguments can be made regarding the various European corporate tax systems. For a discussion that incorporates examples from the European experience, see JOHN CHOWN, THE CORPORATION TAX—A CLOSER LOOK (Institute of Econ. Affairs ed., 1965).

the interest they pay but cannot deduct dividend payments. They can avoid the tax at the shareholder level if they retain their earnings rather than pay dividends but, in the case of small, closely held corporations, this may subject the corporation to an accumulated earnings tax if it does not pay dividends.¹⁷⁰ Business entities can avoid the corporate tax quagmire by doing business as a partnership, but the partnership form exposes partners to unlimited liability and makes it more difficult to raise capital and thus to grow.

A tax system that encourages some things and discourages others provides incentives for corporate executives to make decisions based on tax avoidance rather than on sound business practice. As a result, resources are allocated in a way that is different from what allocation would be in the absence of incentives. This inefficient allocation of resources retards economic growth. At least one study has concluded that the corporate income tax is the least efficient of the major taxes.¹⁷¹ A Treasury Department study concluded that integrating business and income taxes would shift capital to the corporate sector, reduce corporate borrowing, increase dividend payments, and increase Gross Domestic Product by between \$3 billion and \$30 billion.¹⁷²

These studies point out the potential pitfalls that lurk beneath the surface of a corporate income tax. The best course is not to establish a corporate income tax, because such a tax is hidden. Also, corporate taxes retard economic growth by distorting the allocation of resources and by discouraging foreign investments in the emerging economy.¹⁷³

If policymakers determine that a corporate income tax is needed, despite all the negative effects of such a tax, they should: (1) Make rates low and the system simple to understand. A uniform rate that is easy to compute is better than a myriad of rates and complicated rules that require up to hundreds of professionals per company to interpret. (2) Make administration costs low. The cost of administration—both by the tax collector and the private sector—should be as low as possible. U.S. companies devote more than 500 million hours a year just to filling out corporate tax forms.¹⁷⁴ If the average salary of the person filling out the form is \$20 an hour, then just filling out the forms costs corporations \$10 billion a year. And the cost of filling out the forms is only a small

170. I.R.C. § 532 (1995).

171. BALLENTINE, *supra* note 167.

172. Hallman & Joseph G. Haubrich, *Integrating Business and Personal Income Taxes*, in ECONOMIC COMMENTARY, *supra* note 168, at 3. The study referred to was the U.S. Treasury Department's report to Congress.

173. The U.S. tax system has been criticized for the adverse effect it has on foreign investment. For discussions on this point, see GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM (1992); U.S. FOREIGN TAX POLICY AND THE GLOBAL ECONOMY: NEW DIRECTIONS FOR THE 1990s (Institute for Res. on the Econ. of Tax'n ed., 1989).

174. Hallman & Haubrich, *Integrating Business and Personal Income Taxes*, in ECONOMIC COMMENTARY, *supra* note 168, at 2.

percentage of the total cost of tax compliance.¹⁷⁵ (3) Adopt a set of rules that does not discourage investment, either by foreigners or domestic investors.

IV.

THE VALUE ADDED TAX: LESSONS FROM THE WESTERN EXPERIENCE

A. *General Comments*

The value added tax (VAT) can be assessed in a number of ways. It can be assessed at each stage of production, only at the final stage of production, or at the stage when the product is transferred from the retailer to the consumer. This latter form of VAT is often called a retail consumption tax or a turnover tax. In this paper, the VAT term will be used to refer to the tax that is assessed at each stage of production. Note that the United States does not have a national VAT although most states and some counties and cities have a sales tax that is similar to the VAT.

B. *The Value Added Tax*

The value added tax (VAT) suffers from the same major deficiency as most other forms of taxation—it is coercive. It takes property without the owner's consent. However, if one believes that some forms of takings are better than others, one might ask whether the VAT is a viable alternative to the income tax. For years, some commentators have been calling for the replacement of the income tax with some form of VAT. They argue that the income tax discourages production and encourages consumption and leisure whereas the VAT encourages thrift and enterprise.¹⁷⁶ If this is true, then the VAT should be of interest to an emerging economy where economic growth is especially important.¹⁷⁷

In recent years, some commentators in the United States have advocated a VAT not as a replacement for the income tax but as a supplement, because they think that raising more funds via an income tax is not feasible.¹⁷⁸ In a sense,

175. A Coopers & Lybrand study of corporations having sales of \$25 million or more found that the average company assigns 7.4 people to the state and local tax area and 9.3 to the federal tax area. *STATE AND LOCAL TAXES: THE BURDEN GROWS 5* (Coopers & Lybrand ed., 1992).

176. MURRAY L. WEIDENBAUM & ERNEST S. CHRISTIAN, JR., *THE ALLURE OF VALUE-ADDED TAXES: EXAMINING THE PROS AND CONS* 1 (1989).

177. A subtle issue is involved here, whether the tax system should encourage or discourage certain kinds of activity. Those who favor the VAT over the income tax often do so because they think that government should encourage savings over consumption. But is the influencing of taxpayer behavior a legitimate function of government? If government is the servant and taxpayers the masters, should the servant really care what the masters do with their own money?

178. CHARLES E. McLURE, JR., *THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION?* 175 (1987). For a study that considers the relative merits of a VAT as an additional revenue source by comparing it to an income surtax on individuals and corporations, see *CONGRESSIONAL BUDGET OFFICE, EFFECTS OF ADOPTING A VALUE-ADDED TAX* (1992).

However, according to one view, "consumption taxes alone cannot achieve the ability to pay principle and accordingly could not entirely replace an income tax." But, as we have discussed, the ability to pay principle is not a legitimate principle of taxation. *ORGANIZATION FOR ECON. COOPERATION & DEV., TAXING CONSUMPTION* 32 (1988) [hereinafter OECD].

they are right. If income tax rates are raised too high, taxpayers may revolt and vote some politicians out of office in the next election. Thus, because the VAT is a hidden form of taxation—people who ultimately pay¹⁷⁹ it do not know precisely what they are paying—some politicians may prefer to raise revenue not by raising income tax rates but instead by using a VAT to make up the difference. At least one study supports this possibility when it pointed out that once a VAT is in place governments always raise it. This might explain the fact that those Organization for Economic Cooperation and Development (OECD) countries that have a VAT also have much higher tax ratios than those that do not have one.¹⁸⁰

Because the VAT is hidden, it is an unethical way to raise revenue. In essence, the VAT is a dishonest way to raise revenue because of the lack of full disclosure. However, the U.S. government¹⁸¹ is putting increasing pressure on publicly traded corporations to make full disclosure on their financial statements. The Federal Trade Commission pressures banks to fully disclose loan charges. The Food and Drug Administration pressures companies to disclose the content of the cans of food they produce. Yet when a government makes use of a VAT, there seems to be no need for any disclosure.

Furthermore, the blame for the tax may even be shifted onto the corporations that sell the products. When consumers see that corporations charge high prices for their products, they may blame the corporations when, in fact, a large portion of the purchase price is attributable to the VAT. Also, if consumers buy less goods because prices have increased, economic growth is detrimentally affected.

The VAT also has a high cost of administration.¹⁸² It would take thousands of bureaucrats in government to administer it. It would take many hours of the valuable time of businesses to keep the appropriate records and file the proper tax returns.¹⁸³ If there were no VAT, these thousands of individuals could spend their time creating wealth instead of shuffling paper.¹⁸⁴

But the same argument could be made for abolishing the income tax. All other things being equal, a simple, and easily administered VAT might be preferred to a complex, obscure and burdensome income tax. Therefore, simplicity,

179. The question of who ultimately pays a VAT or other consumption tax is a major one, and economists cannot agree on who ultimately pays the tax. For a discussion of this point, see David G. Raboy & Cliff Massa, III, *Who Bears the Burden of Consumption Taxes*, in *THE VALUE ADDED TAX: ORTHODOXY AND NEW THINKING* 39-68 (Murray L. Weidenbaum et al. eds., 1989).

180. GRAHAM BANNOCK, *VAT AND SMALL BUSINESS: EUROPEAN EXPERIENCE AND IMPLICATIONS FOR NORTH AMERICA* 8 (1986).

181. Specifically, the Securities and Exchange Commission and Congress.

182. Barry M. Freeman, *The Japanese Consumption Tax: Value-Added Model or Administrative Nightmare?* 40 *AM. U. L. REV.* 1265 (1991).

183. In England, small businesses complained about the complexity of the British VAT. Their complaints subsided somewhat when the VAT tax forms were simplified. A. R. PREST, *VALUE ADDED TAXATION: THE EXPERIENCE OF THE UNITED KINGDOM* 38 (1980).

184. And where the VAT is used as a supplement to the income tax rather than as a replacement, two sets of bureaucrats and private sector accountants would be required, one to administer the VAT, and the other to administer the income tax.

clarity and administrative burden are issues that must be considered regardless of which form of taxation is chosen.

One advantage of the VAT is that because the tax base for a VAT is much wider than for income taxes, an enormous amount of revenue can be raised with lower rates than would be required for income taxes. The VAT tax base consists basically of the economy's total output of goods and services, plus imports minus exports.¹⁸⁵ Therefore, in the United States a 3.5% VAT could raise as much as a 34% corporate income tax, and a 16% VAT could raise as much as individual income tax rates of 15% and 28%.¹⁸⁶

However, the revenue-raising aspect of a VAT is a double-edged sword. Those who advocate low taxes see the VAT as a threat because the VAT makes it easy for the government to raise revenue. "Conservatives fear that instituting a VAT or a retail sales tax would be as risky as turning over the wine cellar key to an alcoholic."¹⁸⁷

Computing the correct tax might be a problem. Basically, the tax is assessed on the value added, the difference between the value of the product as it comes in the door and the value as it goes out. But in practice the computation would not be that simple. Certain items would probably be exempt, such as food.¹⁸⁸ Policymakers will be tempted to assess different rates for different products and services, thus there would be classification problems.¹⁸⁹ There would be pressure to exempt or charge lower rates to governmental units and nonprofit organizations. Producers who are engaged in both exempt and taxable activities would have to resort to apportionment, which could get quite complicated.¹⁹⁰

Proponents of a VAT contend that the VAT offers several additional advantages over other forms of taxation. First, they claim that the VAT is "neutral" because it is levied at a uniform rate over the whole consumption base.¹⁹¹ Thus, the method of production chosen is not affected by the tax system and producers can shift to more profitable methods of production without affecting their tax

185. WEIDENBAUM & CHRISTIAN, *supra* note 176, at 4.

186. *Id.* These comparisons are based on the tax system in the United States in 1987.

187. McLURE, *supra* note 178, at 176.

188. The author found a very easy way to evade the VAT at a McDonald's in Paris. A VAT is charged on food that is consumed on the premises but not on food that is taken away. All you need do to evade the VAT is to declare that you are taking the food away at the time of purchase, then change your mind and sit down at a table after you have the food in hand. Enforcement would require the hamburger police to be stationed at every McDonald's.

189. Is an antidandruff shampoo, for example, a medicine, and therefore exempt, or a cosmetic, and therefore taxable? French tax officials engaged in an extensive debate over this issue, as is pointed out in WEIDENBAUM & CHRISTIAN, *supra* note 176, at 5.

190. PREST, *supra* note 183, at 26.

191. In fact, it is not neutral, but it is not easy to predict where distortion will occur. The tax is paid by producers, but may be passed on to consumers in the form of higher prices. If it cannot be passed on, then profit margins suffer, shareholders must be content with a lower return on investment, and employment expands less rapidly. And a VAT may adversely affect some lines of business more than others. Any tax also has an adverse effect on economic growth, so it cannot truly be said that a VAT is neutral. A study of several countries confirms that, in practice, the VAT is far from neutral in most cases. BANNOCK, *supra* note 180, at 8.

burden. Second, they point out that there is no penalty for being efficient with a VAT, whereas with an income tax, companies that are more efficient and thus have higher profits, get hit with higher income taxes. Last, they note that a VAT does not subsidize waste, whereas an income tax does because costs are deductible and reduce the amount of income upon which the income tax is assessed.

Those who oppose the VAT give several reasons. First, the VAT is viewed as regressive because those in lower income brackets pay a higher percentage of their income in VAT taxes than those in the higher income brackets.¹⁹² Some relief could be granted to lower income groups by exempting certain items, like food and medicine. However, doing so would make the system more complicated and difficult to administer. Second, a study of European VAT systems found that the VAT is regressive in another way as well. The cost of compliance and administration fall more heavily on small firms than on large ones.¹⁹³ This point should be of special interest to emerging economies, since most economic growth is expected to come from small enterprises rather than from large ones. A VAT could choke off growth before it starts in the case of many small businesses. Third, the VAT can adversely affect economic growth. One econometric study predicted that the U.S. economy would grow 1% more slowly for each 1% VAT and inflation would be one and a half to two percentage points higher during the initial adjustment period.¹⁹⁴ Last, the VAT will likely be collected only in the formal sector of the economy. Evasion will be widespread in the informal sector.¹⁹⁵ This very fact will encourage enterprises to do their business informally rather than join the formal sector.

C. The Turnover Tax

The turnover tax or retail consumption tax is similar to the VAT except that it is charged on the transfer of property either from enterprises to retailers or from retailers to consumers.¹⁹⁶ It could be a single rate or many rates. Retail consumption taxes may be levied at the national, state or local level. In the United States, a retail sales tax is levied on the sale of products (but not services) in nearly all the states. So far, the national government has not seen fit to assess a similar tax at the national level, although there has been talk of instituting such a national tax as a supplement to the income tax.

One advantage of a sales tax over a value added tax is that the sales tax would be levied only on the end user.¹⁹⁷ It would only be assessed at the final

192. This view takes for granted that the ability to pay principle is to be preferred over the cost-benefit principle, which is questionable, at best.

193. BANNOCK, *supra* note 180, at 24-25.

194. WEIDENBAUM & CHRISTIAN, *supra* note 176, at 11. The study they cite is Joel L. Prakken, *The Macroeconomics of Tax Reform, in THE CONSUMPTION TAX: A BETTER ALTERNATIVE?* 117 (Charles E. Walker & Mark A. Bloomfield eds., 1987).

195. The informal part of the economy for an emerging economy is very significant, perhaps more than 50%, although it is impossible to measure.

196. Tanzi, *Tax Reform, in THE ROLE OF TAX REFORM*, *supra* note 140, at 19, 20.

197. OECD, *supra* note 178, at 68-69.

stage of production rather than along every step of the way. Thus the amount of bureaucracy and paper shuffling would be much less, compared to the VAT.¹⁹⁸ The cost of administering a national sales tax would be much lower than administering a VAT, especially in jurisdictions that already have a sales tax, since the administrative mechanism would already be in place.

Another relative advantage of a sales tax, at any level—national, state or local—is that, unlike the VAT, it is visible. Therefore, those paying the sales tax can see how much they are paying because the tax is assessed on every purchase. Where the tax is visible there is resistance, so there is a built-in restraint on tax increases. Politicians will be less likely to raise the tax because their efforts will become known immediately to the taxpayers.¹⁹⁹

Another advantage of a sales tax is present when the tax is assessed at the state or local level — tax competition.²⁰⁰ If neighboring localities or states each assess a sales tax, there is a tendency for residents who live near the border to go shopping in the place that has the lower tax rate. For example, New Jersey does not assess a sales tax on clothes and New York assesses a high sales tax on clothes; thus New York residents tend to shop for clothes in New Jersey, even if they pay a few dollars to come to New Jersey. This competition for shoppers between New York and New Jersey has become so upsetting to New York tax officials that they are stalking New Jersey shopping malls and taking down auto license plate numbers in an attempt to identify New York shoppers so that the tax officials can assess a use tax against them.²⁰¹ The use tax law requires people who purchase merchandise in another state to pay a tax to New York state that is equal to the difference between the tax they paid on the out-of-state purchase and the tax they would have owed if they had made the purchase in New York. However, use tax rules are almost universally ignored by New York residents who shop in New Jersey.

Furthermore, tax collections are affected more when shoppers make large purchases. For example, a New York resident could save hundreds of dollars by purchasing a \$10,000 fur coat in New Jersey rather than in New York. This depresses the fur business in New York and leads to increased business for New Jersey furriers. Additionally, those who purchase furs in New Jersey may also buy lunch or go to a movie while they are there. Thus, New York's economy suffers even more.

This competition places pressure on local politicians not to raise taxes. Local residents may not vote for any politician who raises their sales taxes. Local

198. *Id.* at 99-101.

199. Of course, policymakers can make the retail sales tax more hidden by including it in the purchase price of products, in which case it would look much like an excise tax. This approach would violate the principle that taxes should be visible instead of hidden, so this approach should not be employed.

200. This phenomenon is discussed in Timothy Brown, *Interjurisdictional Tax Competition: An Economic Perspective*, 68 NEBR. L. REV. 652 (1989).

201. Thomas Moran, *N.Y. Tax Collectors Staking Out Malls: Want Payback on N.J. Shopping Deals*, THE (BERGEN COUNTY, NJ) RECORD, Dec. 10, 1992, at A1.

businesses, who stand to lose business if the sales tax is increased, may threaten not to make campaign contributions to any politicians who vote to raise the sales tax. If taxes are too high, some businesses may close up shop and move to a low tax state. This is precisely what is happening in New York because of the relatively high New York state and city sales tax as compared to the surrounding states.²⁰²

Another advantage of sales taxes is that everyone pays the same rate. Because rates are not graduated based on income, the tax system does not increase class conflict by assessing higher rates on the rich than on the poor. Anyone can avoid the sales tax simply by not buying. And, since the rich tend to spend more than the poor, the rich end up paying more in sales taxes than the poor anyway. Economists call this result horizontal and vertical equity because equal taxpayers are treated equally, and taxpayers who earn more money pay more taxes.²⁰³

Taxing sales rather than income may also positively affect the savings rate. If people are not taxed until they buy something, they will tend to save rather than consume. If savings increase relative to income, the supply of funds available for investment will increase. The greater availability of funds will lead to lower interest rates and lower cost of capital, which will increase investments, which in the long run will increase economic growth and create jobs. This effect is not present with an income tax because income and investment are both taxed. With an income tax, there is more of a tendency to consume since the after tax return on investment is lower than if no tax were assessed.²⁰⁴ Studies have estimated that the tax rate on a national sales tax in the United States would have to be about 12% to 15% in order to raise the same amount of revenue that is now being raised by the individual and corporate income tax.²⁰⁵

If a national sales tax replaced the income tax in the United States,²⁰⁶ a number of other beneficial effects would result. Since a sales tax is much simpler and easier to assess than an income tax, there would no longer be a need for individuals or businesses to file tax returns. Thus, hundreds of millions of hours would be freed up for other uses, such as creating wealth or increasing leisure

202. *Tax Freedom Day 1991 is May 8—Latest Date Ever: State Tax Freedom Days Range from April 24 to May 26*, 35 TAX FEATURES 1 (1991).

203. Mark Skousen makes this point in *ECONOMICS ON TRIAL*, *supra* note 7, at 168.

204. The reason for this tendency is that there is no tax disincentive for consuming because the tax has already been assessed before consumption.

A tax can either encourage saving or consumption. A retail consumption tax discourages consumption because people have to pay the tax if and when they consume. A consumption tax also encourages investment because consumption taxes do not tax investment.

The income tax does not discourage consumption because there is no tax on consumption with an income tax. The tax has already been assessed on income. The income tax discourages investment because the return on investment (interest, dividends, or capital gain) is taxed. Therefore, where there is an income tax, consumption looks more enticing, in relative terms, than where there is a consumption tax, because consumption is not taxed, and income is.

205. SKOUSEN, *supra* note 7, at 169.

206. The United States is being used as an example here, but the same rules apply to any country that has an income tax.

(which would be beneficial for the leisure industries).²⁰⁷ The U.S. tax code,²⁰⁸ which now consists of thousands of pages of law and regulations, could be almost entirely scrapped. The thousands of cases (from three federal court systems)²⁰⁹ and thousands of revenue rulings, revenue procedures and other IRS pronouncements could be ignored because they would become irrelevant. The hundreds of thousands of people who administer the tax system at the national level²¹⁰ and the many corporate accountants who must keep tax records for their companies could put their time and effort into more productive pursuits.

Replacing the income tax with a sales tax would also greatly reduce the extent of government intrusion into the private lives of its citizens. The government would have no reason to audit the tax returns of millions of individuals²¹¹ and to invade their privacy.²¹² Replacing the income tax with a sales tax would thus increase individual freedom and reduce official corruption and the use of arbitrary power.²¹³

The major criticism of the sales tax is that it is "regressive" because poor people pay a larger portion of their income in sales taxes than do rich people. This view makes the assumption that poor people have a higher propensity to consume, and rich people have a higher propensity to save. There are many problems with this propensity to consume theory including that the empirical evidence does not consistently support the view that the rich save a higher percentage of their income than the poor.²¹⁴ One study conducted by Henry Hazlitt found that savings, as a percentage of income, declined for seven years out of the eleven years under study.²¹⁵ Another study, conducted by Simon Kuznets,

207. Any kind of an economic shift produces winners and losers. If the income tax were abolished, the general public would benefit, but those who work in the income tax industry would have to find new jobs. One factor inherent in the market mechanism is the tendency for resources (labor resources, in this case) to shift out of less productive uses and into more productive uses. Once the income tax is abolished, these people would seek work in areas where their services could be utilized to create wealth rather than to redistribute existing wealth.

208. Title 26, United States Code.

209. Three different federal court systems hear tax cases in the United States. Cases can be initiated in federal district court, the Tax Court, or the Claims Court. Appeals from these courts go to the federal appellate court, and then, perhaps to the Supreme Court. And the various courts sometimes reach diametrically opposed conclusions about similar or identical fact situations, which makes the system more complicated and less certain, not to mention expensive and time-consuming. All this could be eliminated if the income tax were abolished.

210. The IRS has more than 120,000 employees.

211. The IRS audits about 1 million tax returns a year, or slightly less than 1% of the income tax returns filed annually in the United States.

212. It is true that the government could crack down on the informal, underground sector, if they could find it. But it would not harass and destroy the lives of honest citizens, like it is doing now.

213. For a treatise on IRS abuse, see DAVID BURNHAM, *A LAW UNTO ITSELF: POWER, POLITICS AND THE IRS* (1989).

214. For more on this point, see HENRY HAZLITT, *THE FAILURE OF THE "NEW ECONOMICS"* 98 (1959), especially at 113-115.

215. *Id.* at 113.

concluded that savings, as a percentage of income, remains constant over time.²¹⁶

Another problem with the regressivity view is that those who advocate it generally believe taxes should be progressive. That is, they believe a higher percentage of income should be taken from the rich than from the poor. These advocates take the Marxist "ability to pay" approach rather than the more equitable cost-benefit approach. This view, aside from being inequitable, also exacerbates class conflict and reduces social harmony because it pits one class against another.

With a sales tax, the rich pay more than the poor in absolute terms because they spend more. However, the rich also receive more benefit from government than do the poor since they have more property in need of protection. So the sales tax works a rough justice of sorts. The rich receive more benefit from government services (protection of property) and they pay more for it.

V.

OTHER MEANS OF RAISING REVENUE

A. Overview

The income tax and the value added or retail consumption tax are major sources of revenue for most developed countries. But they are not the only forms of revenue. A number of other sources are also tapped with varying degrees of success. This section discusses other significant sources most countries use to some extent.

B. Property Taxation

In the United States, property taxes are assessed mostly by state and local governments. Real and personal property taxes account for about 37% of state and local governments' total tax receipts.²¹⁷ Much of what is collected, especially from real estate taxes, is used to pay for local services. For a long time, many people believed that real property taxes constitute the most inequitable form of taxation. Yet, it is still a major form of financing local government.²¹⁸

Property taxation has some of the same attributes of income taxation. Both are coercive rather than voluntary. Both cause economic distortions. However, there are some differences as well.

One difference is the competitive effect. With the federal individual income tax, for example, individuals have the option of either paying the tax or

216. ALVIN H. HANSEN, *A GUIDE TO KEYNES* 75 (1953).

217. COOPERS & LYBRAND, *STATE AND LOCAL TAXES: THE BURDEN GROWS* 3 (1992). State and local governments get their tax revenues from the following sources: real property taxes, 22%; personal property taxes, 15%; sales and use taxes, 16%; corporate income taxes, 38%; capital-based franchise taxes, 9%.

218. For a series of papers suggesting ways in which the property tax can be reformed, see *PROPERTY TAX REFORM* (George E. Peterson ed., 1973).

moving to another country.²¹⁹ But avoiding property taxes is easier. Individuals who believe they are paying too high a property tax can often get a tax break by moving a few miles down the road to another community with lower tax rates. This competitive tax effect also occurs for other kinds of taxes, such as the state individual and corporate income tax. For example, as was mentioned above, some individuals and businesses are moving out of New York and into New Jersey to take advantage of lower tax rates.

One positive attribute of the competitive effect, from the taxpayer's perspective, is the restraint it places on government expenditures.²²⁰ Governments have monopolies over a certain geographic territory, and their behavior conforms to general monopoly theory. As with any monopoly, costs tend to be higher and the quality of services tends to be lower than where there is competition. One reason for this tendency is that there is no incentive to improve the quality of service or cut costs because consumers have no place else to go. However, the monopolistic position of local governments is not absolute. The government that has a monopoly over the geographic territory of New York must compete with the neighboring monopoly across the river in New Jersey. If citizens and businesses in one state think they can get a better deal in another state, they tend to move, thereby depleting the tax base of the state that offers a less desirable package of services.

Of course, not everyone moves to avoid high taxes. Sometimes, people move to a higher tax community if they think they can improve their situation. For example, in the United States many parents move to a new community to take advantage of the local schools. In effect, these people are willing to trade higher taxes for a more desirable package of services.

Financing public education with property taxes is unjust to homeowners without children and to homeowners who pay for private schools for their children because these homeowners are being forced to pay for the education of other people's children.

Another problem with financing education through property taxes is that the tax is hidden because few realize the full cost of the education. The "free" education costs perhaps \$4,000 to \$6,000 or more per child. Because taxpayers do not know the true cost of education, there is less of an incentive to restrain educational spending.

Furthermore, although only property owners are supposed to owe the tax, even people who do not own homes pay property taxes. Landlords generally tack on the property tax to their monthly rental bills, if possible. And, if the tax cannot be passed on to tenants in their rent, tenants wind up paying anyway

219. Actually, they must do more than just move to another country to avoid paying the U.S. individual income tax. The United States is one of the few countries that taxes its citizens even if they live outside the United States. So to avoid the tax, they must not only move but also give up their citizenship.

220. Some of these points are discussed in Timothy Brown, *Interjurisdictional Tax Competition: An Economic Perspective*, 68 NEBR. L. REV. 652 (1989).

because when landlords pay the tax they have less money for the upkeep of the apartments. Thus, landlords will cut costs by deferring maintenance, reducing heat in the building, and so forth. So tenants pay the tax anyway by not getting their full money's worth.

Finally, all rents may be forced up because landlords cannot invest in more rental units. Since the supply of available housing is thus crimped, the rent will increase.

C. Excise Taxes

Excise taxes are assessed on a number of items, ranging from alcohol and tobacco products to gasoline, airline tickets, telephones, gambling, foreign insurance policies, and oil spills. In many ways, an excise tax is like a sales tax²²¹ only more selective because it focuses on a single item or group of related items. Unlike a sales tax, which assesses the same rate on a broad range of items, an excise tax can charge different tax rates for different items. This can be good if policymakers want to penalize certain activities, like smoking or consuming alcoholic beverages.²²² However, multiple rates can have the effect of increasing the complexities and inequities of the system.

Excise taxes have many negative attributes. (1) They are based on coercion, so they violate property rights. (2) They can be an administrative nightmare. (3) They cause relative prices to shift, which causes consumers at the margin to alter their purchase decisions, thus distorting the economy. (4) They can affect behavior. For instance, a tax rise will cause some consumers not to buy the thing being taxed; if the tax is removed or reduced, more consumers will tend to buy more of the item. (5) They may encourage tax evasion and feed organized crime, as in the case of excise taxes on alcohol and tobacco.²²³

One criticism of excise taxes on alcohol and tobacco is that the tax falls disproportionately on the poor, since they spend a disproportionate percentage of their income on these products. This argument is based on the ability to pay principle, as discussed above. However, the argument is also used by the tobacco and alcohol industries that stand to benefit if these taxes are reduced or abolished.²²⁴

221. HARVEY S. ROSEN, PUBLIC FINANCE 460 (2d ed. 1988).

222. It is questionable whether the tax system can legitimately be used to punish this kind of activity, since the purpose of government is supposed to be to serve the people, not to regulate their private activities.

223. As the amount of the excise tax increases, more consumers will decide it is to their benefit to buy cigarettes and alcoholic beverages that do not have a tax stamp (sold by organized crime) or that have a counterfeit tax stamp. In Canada, for example, where tobacco taxes are high, a large percentage of the cigarettes sold (especially in Quebec) are sold untaxed. Organized crime smuggles them into Canada from North Carolina and elsewhere. Rosanna Tamburri, *Canada Rolls Back Tobacco Taxes, Imposes Surtax in Bid to End Smuggling*, WALL ST. J., Feb. 9, 1994, at B12

224. One such study to support the alcohol industry's position was prepared by the accounting firm of KPMG Peat Marwick for the National Wine Coalition. The results of this study were reported in *Low-Income Individuals Pay Disproportionate Share of Wine Excise Taxes, Study Finds*, DAILY TAX REP. (BNA) G-11 (1992).

Another issue regarding excise taxes is the welfare effect. Excise taxes reduce output of the taxed commodity and distort the allocation of resources. The same is true of income taxes. Some economists have argued that an excise tax, is better than an income tax, and others have argued the opposite. Both sides offer good points to justify their position. But the fact remains that any tax causes distortion. Excise taxes cause more distortion on the segments of the economy they tax; income taxes have a more broadly based distortionary effect. However, excise taxes have ripple effects; they distort other segments of the economy as well.²²⁵ That is, excise taxes are targeted at certain products, but their effect does not stop with those targeted products. The ripple effect occurs when the cost of the excise tax is spread to other sectors of the economy. For example, the gasoline excise tax is spread to the cargo that the trucks transport. The cost is then passed on to consumers when they buy the cargo at retail.

Excise taxes suffer from several deficiencies. They are coercive, hidden, and they do not raise much revenue, at least when compared to the income and sales/value added tax. They tend to be abused when used to alter behavior—sin taxes on alcohol and tobacco—which is not a legitimate function of government. There is really no need for an emerging economy to adopt excise taxes. These taxes have few positive attributes.

D. Estate, Inheritance and Gift Taxes

Estate, inheritance, and gift taxes are other means of raising revenue. They are related since they all deal with the taking of accumulated wealth. Estate taxes are levied on the estate of a deceased person. Inheritance taxes are levied on those who receive the property of a deceased person. Gift taxes are levied either on the donor or donee for property that is transferred before death. All three are based on the ability to pay principle. It would be difficult to argue that these taxes are justified on a cost-benefit basis since dead people derive no benefit from government.²²⁶

Karl Marx advocated a 100% inheritance tax as a means of destroying capitalism.²²⁷ And with good reason. These taxes are an effective way to confiscate wealth. If the goal is to reduce inequality of wealth or to make capital vanish, these taxes will help to achieve that goal.²²⁸ In general, because there are many

225. For some discussions of these points, see Milton Friedman, *The "Welfare" Effects of an Income Tax and an Excise Tax*, 60 J. POL. ECON. 25 (1952), reprinted with corrections in MILTON FRIEDMAN, *ESSAYS IN POSITIVE ECONOMICS* 100-113 (1953); Earl R. Rolph & George F. Break, *The Welfare Aspects of Excise Taxes*, 57 J. POL. ECON. 46-54 (1949).

226. True, the gift tax is different from estate and inheritance taxes, in the sense that the recipient or donor is not dead. But there is an exemption, which is meant to take the tax bite out of small gifts. This gift tax exemption is aimed at reducing or eliminating the tax that lower income people would have to pay. It is a soak-the-rich scheme, intended to prevent the rich from giving away large chunks of their property before they die in order to avoid the estate tax. A gift tax is often just an alternative to the estate tax.

227. MARX, *supra* note 146.

228. I am not saying that equalizing income is a legitimate goal of government, because it is not. For a detailed discussion of this point, see DE JOUVENEL, *supra* note 6.

ways to avoid paying these taxes²²⁹ they do not raise much revenue, and government coffers would not be depleted much if these taxes were abolished completely. So why have them?

While there seem to be no clear benefits to implementing any of these taxes, there are some drawbacks. Wealth tends to leave a country that has such taxes. People who have managed to accumulate wealth tend to put it in places where it will not be confiscated. Other people choose not to make an effort to save and accumulate wealth since it will be confiscated anyway.²³⁰ A number of studies have shown that the right to inherit plays an important role in motivating savings. One study suggests that in the United States, as much as two-thirds of all capital accumulation is due to inheritances. A similar statistic might be applied to other countries as well.²³¹ Therefore, savings, investment, and wealth accumulation suffer because the taxes remove incentives to accumulate wealth. Economic growth must suffer as a result. Emerging economies are least able to afford this dissipation of resources. In fact, they should consider becoming tax havens—places where people can feel safe sending their accumulated wealth to protect it from confiscation in other countries. Such a policy would provide much needed capital at little cost. In the United States, the state of Florida has attracted the accumulated wealth of retired people because it does not have an inheritance tax. When people retire, they move to Florida and bring their lifetime savings with them. This has caused a mini-boom in the trust and wealth management industries. Emerging economies would do well to emulate Florida in this respect.

Another problem with estate and gift tax law in the United States is that they are extremely complicated. Even tax planners cannot always be certain that they are shielding their clients from tax liability and thousands of court cases involving estate and gift taxes have been heard over the years. The resources that are spent administering these tax laws could be better spent elsewhere.²³²

E. Social Security Taxes

In both the United States and Europe, social security taxes are usually taken directly out of payroll. Some rates are quite high. In Hungary, the rate was 53% a few years ago.²³³ The rate in the Czech and Slovak Federal Republic jumped from 20% to 50% in 1989.²³⁴ Rates in the Soviet Union rose from 12.5% to

229. Some commentators even go so far as to say that these taxes are “voluntary,” since they are paid only by those who are too stupid to plan for their death. G. COOPER, *A VOLUNTARY TAX? NEW PERSPECTIVES ON SOPHISTICATED ESTATE TAX AVOIDANCE* (1979), as cited in JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 559 (2d ed. 1988).

230. STIGLITZ, *supra* note 229, at 558.

231. Laurence Kotlikoff & Lawrence Summers, *The Role of Intergenerational Transfers in Aggregate Capital Accumulation*, 89 J. POL. ECON. 706 (1981).

232. For a good example that illustrates the complexity of just one estate tax provision, see *Estate of Clayton v. Commissioner of Internal Revenue*, 976 F.2d 1486 (5th Cir. 1992).

233. Tanzi, *Tax Reform*, in *THE ROLE OF TAX REFORM*, *supra* note 140, at 19, 25.

234. *Id.*

37% in 1991.²³⁵ One problem with such high rates is that companies hesitate to give wage increases if their payroll taxes will increase as a result.

Rates in the United States are much lower. The combined employer and employee share add up to 15.3% of wages.²³⁶ Additionally, the tax stops being collected after annual income reaches a certain base level.²³⁷ However, the rates and the base income level have been rising and they are expected to continue rising in the future.

Emerging economies that want to emulate the social security systems of the western democracies would do well to study western systems first. Social security is one of the worst investments anyone could make. In the United States, social security was established during the depression of the 1930s to ensure that people would have some kind of retirement income.²³⁸ It started out small, with only a dollar or less being taken out of workers' paychecks to finance the program.²³⁹ Employers paid an equal portion.²⁴⁰ Today the combined employee and employer withholdings equal 15.3% of a worker's paycheck,²⁴¹ with only the anticipation of increased withholdings in the future.

In part, the problem arises because the funds collected are never deposited in a trust fund for accumulation until retirement. Instead, money collected today goes directly to support people who have retired. Accordingly, those now working must depend on a later generation to support them when they retire. Moreover, because the birthrate is declining, people are living longer, and people are retiring earlier, the funds being taken out of the system will soon exceed the funds being put into it. The system is becoming strained to the breaking point, which exacerbates the intergenerational tension caused because younger people are being forced to support the elderly.²⁴² Additionally, there is a systematic disincentive to work beyond retirement age because one is automatically disqualified from receiving any social security benefits for earning over a certain, minimal amount. Thus many seasoned, knowledgeable and productive people are being encouraged to retire when they should be encouraged to contribute to the economic growth of the economy.²⁴³

235. *Id.*

236. WEST'S FEDERAL TAXATION: INDIVIDUAL INCOME TAXES 1-15 (William H. Hoffman et al. eds., 1993).

237. *Id.*

238. ALDONA E. ROBBINS, THE ABC'S OF SOCIAL SECURITY 2 (Institute for Res. on the Econ. of Tax'n ed., 1988).

239. See John C. Goodman, *Private Alternatives to Social Security: The Experience of Other Countries*, in SOCIAL SECURITY: PROSPECTS FOR REAL REFORM 103 (Peter J. Ferrara ed., 1985).

240. *Id.*

241. In some European systems, the percentage is much higher. It has been estimated that, in the U.S. case, unless something is done to reverse the situation, it will eventually be necessary to take 40% to 50% of payroll in order to meet social security obligations. See *id.*

242. Laurence J. Kotlikoff raises this point in GENERATIONAL ACCOUNTING: KNOWING WHO PAYS, AND WHEN, FOR WHAT WE SPEND (1992), reviewed by Susan Lee, *Tax-System Troubles*, WALL ST. J., Apr. 28, 1992, at A18.

243. ALDONA & GARY ROBBINS, PAYING PEOPLE NOT TO WORK: THE ECONOMIC COST OF THE SOCIAL SECURITY RETIREMENT EARNINGS LIMIT (Institute for Pol'y Innovation Pol'y Rep. No. 101 & National Center for Pol'y Analysis Pol'y Rep. No. 142, 1989).

Another part of the problem is the consistent mismanagement of the system by the bureaucrats who have been in control of the program.²⁴⁴ However, politicians are afraid to call for reform, lest they be voted out of office by the millions of retirees who fear having their benefits cut off or reduced.²⁴⁵

If policymakers *abroad* decide that they must have government involvement in *their* retirement system, there are better ways to do it than that being done by the western democracies.²⁴⁶ A fully privatized system offers several benefits.²⁴⁷ Perhaps the most important benefit is that the money taken from paychecks will *actually* be set aside and invested. In the United States, if someone dies before retirement, that person's heirs receive nothing back for all the thousands of dollars that were taken from them over the years.

Under a privatized system, the funds taken from paychecks would be invested in stocks, bonds, mutual funds or some other investment vehicle that would grow over time. Those who contribute would be accumulating wealth and would have a property right in the accumulation. The whole economy would benefit because the quantity of capital available for borrowing and investment would become immense, thus reducing interest rates and making it easier to borrow. Mortgage rates would be lower, causing the housing industry to expand and create thousands of jobs and hundreds of thousands of housing units. Business loans would be cheaper because of the lower interest rate; this would aid economic growth and create millions of jobs. And, when people retire, they would not have to worry about being poor in their old age—a major psychic benefit not now present.

F. Tariffs

Before the income tax, tariffs were one of the primary methods the United States used to raise revenue for government. In recent years, tariffs have been used more to protect domestic industry from foreign competition than to raise revenue. It may be that the public interest would be better served by abolishing all tariffs, since, in the aggregate, the vast majority of people stand to gain more than they would lose by doing away with tariffs.

244. MARTHA DERTHICK, *AGENCY UNDER STRESS: THE SOCIAL SECURITY ADMINISTRATION IN AMERICAN GOVERNMENT* (1990).

245. Loren E. Lomasky, *Is Social Security Politically Untouchable?*, 5 CATO J. 157 (1985).

246. There is an ethical question here since government is confiscating property—out of wages—to pay for someone's retirement. If coercion must be used, it is better that it be used to put money aside for those who are paying rather than for those who are already retired. But an even larger question must also be raised here: Is forcing citizens to save a legitimate function of government? Milton Friedman and others have concluded that it is not. See MILTON FRIEDMAN, *CAPITALISM & FREEDOM* 187-89 (1962).

247. A number of proposals have been put forth over the years for privatizing the social security system. For example, see James M. Buchanan & Colin D. Campbell, *Voluntary Social Security*, WALL ST. J., Dec. 20, 1966, at A14; PETER J. FERRARA, *SOCIAL SECURITY REFORM: THE FAMILY PLAN* (1982); HENRY J. AARON ET AL., *CAN AMERICA AFFORD TO GROW OLD?* 117-20 (1989); PETER J. FERRARA, *SOCIAL SECURITY: THE INHERENT CONTRADICTION* (1980).

One main problem with tariffs is that they raise the prices that consumers must pay for imported products; this causes living standards to decline. Various estimates have placed the cost of trade protectionism in the United States at perhaps \$65 to \$80 billion a year or more.²⁴⁸ And, protectionism destroys more jobs than it creates, which is especially harmful to an emerging economy trying to expand employment.²⁴⁹

Protectionism also enhances tension between different groups. Since producers want government protection from foreign competition, and consumers want low prices and higher quality, protectionism pits consumers against producers. Protectionism also pits domestic industries against each other. The steel industry calls for government help in stemming the flow of cheap foreign steel, but the auto industry wants to buy cheap foreign steel to keep its own costs low so it can compete with foreign auto producers.²⁵⁰ Tariffs reduce social harmony without any corresponding general benefit.

Tariffs do little good. They do not raise much revenue. They distort trade. They protect special interests at the expense of the general public. They make trade partners mad. They violate property rights. Emerging economies would be well advised not to have any tariffs. The absence of trade barriers such as tariffs will make it much easier for assets to flow to their most productive uses, which is exactly what emerging economies need desperately.

G. Capital Gains Taxes

The capital gains tax is assessed when certain assets are sold at a "profit."²⁵¹ For example, if an individual (or corporation) bought 100 shares of stock in 1975 for \$1,000 and sells the stock in 1993 for \$1,500, the "profit" on the sale is \$500. If the capital gains tax is 30%, then the tax liability is \$150 (30% of \$500). But has there really been a gain? If inflation between 1975 and 1993 has been 300%, then the purchasing power of \$1,000 in 1975 dollars would be the equivalent of \$3,000 in 1993 dollars. So, in fact, the owner of the stock incurred a real loss of \$1,500 on the sale of the stock—the difference between the \$3,000 purchasing power equivalent in 1993 dollars and the \$1,500 received on the sale. However, the stockholder still has to pay a tax.

A number of commentators have pointed out that this result is grossly unfair. In effect, the taxpayer loses twice, once when he has to sell the stock at a loss (in terms of purchasing power) and again when he has to pay a tax on a gain that he never realized. At the very least, the capital gains tax should take inflation into account, a complicated scheme. A study by the National Bureau of

248. GARY CLYDE HUFBAUER ET AL., *TRADE PROTECTION IN THE UNITED STATES: 31 CASE STUDIES* (1986).

249. *Id.*

250. I.M. DESTLER & JOHN S. ODELL, *ANTI-PROTECTION: CHANGING FORCES IN UNITED STATES TRADE POLITICS* (1987).

251. I.R.C. § 1221 (1995).

Economic Research found that, because of the Laffer Curve effect,²⁵² if the tax on capital gains in the United States were abolished the government would actually realize slightly more revenue than if there were a tax.

The argument has been made more than once that high capital gains tax rates retard economic growth. Capital that is not taxed is available for further investment, which leads to industrial expansion and job creation. In fact, most industrial countries either exempt capital gains from taxation completely or have a very low capital gains tax rate. And the countries with high economic growth rates, such as Germany, Japan, the Netherlands and Italy, all have low or no capital gains tax, while high-rate countries like Great Britain, Canada and the United States all have low rates of economic growth.²⁵³

Another problem with taxing capital gains is the administrative costs both in the public and private sectors. While indexing capital gains would be less unfair than not indexing, it would also increase the administrative burden.

Furthermore, the amount of revenue raised by a capital gains tax is small compared to what is raised by an income or value added tax. To remain competitive and enhance economic growth, which is especially important in an emerging economy, it would probably be a good idea not to have any taxes on capital.

H. Printing Money

Printing money is one of the easiest methods for an emerging economy to raise revenue, and one of the most harmful.²⁵⁴ Printing money leads to inflation, alters behavior, and causes distortion in the economy. The price mechanism, which acts as a signaling device for resource allocation, cannot accurately function when prices are continuously rising. Foreign investors hesitate to invest in countries with high inflation because inflation increases uncertainty. Inflationary expectations cause people to spend rather than save and invest, which is especially counterproductive in an economy that needs growth. While some economists take the position that a stable rate of inflation fosters sound eco-

252. This study was conducted in 1983 by Roger Gordon and Joel Slemrod and was cited by Payne, *supra* note 67, at 20-21.

The Laffer Curve is named after Arthur Laffer, the economist who first devised it on a napkin while in a restaurant. The Laffer Curve holds that if tax rates are too high, governments may actually increase their revenues by decreasing the tax rate. For example, if the marginal tax rate is 100%, government will not collect much revenue because people at the margin will tend to stop working (or stop reporting their income). If the rate drops to 95%, it will collect more revenue than if the rate were 100%. If the rate drops to 60%, it may collect even more revenue. But if the rate drops to 5%, it probably will collect less total revenue than if the rate were 10%. There is some optimum tax rate at which government will maximize its revenue, and that rate is less than 100%. Laffer advocated reducing tax rates during the 1980s because he thought they were too high and that reduced rates would produce more revenue.

253. Mark Skousen points this out in *ECONOMICS ON TRIAL*, *supra* note 7, at 170-171.

254. Geoffrey Brennan and James M. Buchanan discuss inflation as a tax in *THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION* 109-134 (1980).

conomic decisions,²⁵⁵ others argue that zero inflation does an even better job²⁵⁶ and that a gently declining price level might be better yet.²⁵⁷

Resorting to inflation to raise revenue is also a dishonest form of taxation, since it obtains revenue without legislating a tax increase. Thus, it is taxation without representation. Economists have proposed that the inflation tax be neutralized by indexing,²⁵⁸ and this method has been tried with varying degrees of success in several countries.²⁵⁹ But indexing does not stop inflation or the misallocation of economic resources.

A long-term solution proposed by F.A. Hayek²⁶⁰ and others is the privatization of the money supply. Privatizing the money supply would stop inflation dead in its tracks and would take away the government monopoly on money. This solution is especially enticing for an emerging economy that might now have a currency that is not recognized beyond its own borders—privatization could fill the void that now exists. Privatizing the currency of a western democracy might prove to be more difficult because its currency might already be widely accepted and people might see little or no need to make any changes to the currency.

I. User Fees

User fees are fairer than some other forms of taxation because they link cost to benefit. Those who use the service pay for it and those who do not use the service are not forced to subsidize someone else's use of it. Examples of user fees include government-owned electric, gas and water company charges,²⁶¹ subway and bus fares, garbage collection fees, admission fees to public zoos, parks and museums, turnpike tolls,²⁶² and gasoline taxes. Also, user fees are not as coercive as most other forms of taxation because they do not force some people to pay for other people's benefits.

One major area where user fees could be applied is in the financing of public schools. Under the present U.S. system, property owners are forced to

255. James G. Hoehn, *Stable Inflation Fosters Sound Economic Decisions*, in *ECONOMIC COMMENTARY* (Federal Reserve Bank of Cleveland ed., 1988).

256. William T. Gavin & Alan C. Stockman, *The Case for Zero Inflation*, in *ECONOMIC COMMENTARY*, *supra* note 255.

257. ROTHBARD, *supra* note 7, at 865.

258. Indexing involves moving the tax brackets to account for increases in the general price level. For example, if the tax rate is 30% on incomes between \$20,000 and \$29,999 in 1994 and the consumer price index increases by 4% during 1995, the 30% bracket for 1995 will be \$20,800 to \$31,199 (multiply last year's bracket by 1.04).

259. DAVID R. MORGAN, *OVER-TAXATION BY INFLATION* (1977).

260. F.A. HAYEK, *CHOICE IN CURRENCY: A WAY TO STOP INFLATION* (1976); F.A. HAYEK, *DENATIONALIZATION OF MONEY: THE ARGUMENT REFINED* (3d ed. 1990).

261. It is questionable whether the government should be involved in these activities because the market—private companies—can do a better job at a lower price, but that is another issue. For examples of cases where the private sector can provide services more efficiently and at lower cost than government, see POOLE, *supra* note 3; FITZGERALD, *supra* note 3; BENNETT & JOHNSON, *supra* note 3.

262. G.J. ROTH, *A SELF-FINANCING ROAD SYSTEM* (1966).

pay for the education of other people's children. The public school system is free (in the sense that those who use the service do not have to directly pay for it), and the cost is borne by residents in the community who own real estate and, to a lesser extent, taxpayers who earn income. Since the schools of emerging countries have often been used for indoctrination as much as for education, it would be especially beneficial for emerging economies to adopt a user fee approach to education. Privatization of their school system would make it impossible for some future government to use the schools for indoctrination.

User fees can be used to provide a number of services often thought to be in the sole domain of government, including fire prevention and, in some cases, even police protection. In the case of fire protection, individuals in some communities in the United States can subscribe with a local provider for fire protection. If their house catches fire they call the fire prevention agency and have the fire put out free of charge. People get protection even if they don't subscribe to the service, although if they ask for assistance without being subscribers, they are assessed a premium. Fire prevention services in these communities have proven to be more efficient and less costly than similar services provided by government. Homeowners in communities that offer this approach to fire prevention have found that the fire insurance premiums they pay are lower in cases where the services are provided privately rather than by government.²⁶³

Even parts of the criminal justice system can be set up on a user fee basis.²⁶⁴ In the United States, the American Arbitration Association and other groups are available to settle disputes and can do so much faster and cheaper than the government court system. Some commentators have advocated the establishment of competing private police forces that consumers could subscribe to just as they now do for private fire protection.²⁶⁵ In fact, some police forces are already privatized, such as in cases where companies hire private security guards to protect their property.

J. Lotteries

From a human rights perspective, a lottery is the best kind of tax because it involves absolutely no coercion. No one's property is confiscated. No one is forced to pay for someone else's benefits. Lotteries involve no parasitism. Several states in the United States have instituted lotteries in order to raise revenue. Florida's lottery raises more than \$2 billion a year.²⁶⁶ Other state lotteries also raise large sums. In an emerging economy that limits spending and privatizes wherever possible, it might be possible to raise all the funds that are needed to

263. For more on the private provision of fire protection, see FITZGERALD, *supra* note 3, at 71-80; SAVAS, *supra* note 3, at 95-96; POOLE, *supra* note 3, at 62-78. These books also cite examples where police protection has been provided privately.

264. See POOLE, *supra* note 3, at 51-61; FITZGERALD, *supra* note 3, at 93-119.

265. ROTHBARD, *supra* note 46, at 123.

266. *Record-Breaking Lottery*, DAILY TAX REP. (BNA) H-2 (Jan. 19, 1990).

run government by using just a lottery and user fees, thus doing away with the need for coercive taxation.

Lotteries can be relatively easy and inexpensive to administer and, if store owners are permitted to sell lottery tickets, lotteries can provide employment in the private sector. However, some people do not favor the use of lotteries to raise government revenue. One reason often given is that gambling is a sin and the government should discourage sin, rather than encourage it. Emerging economies that have a population with strong moral beliefs might run into problems with a lottery.

Lotteries have many advantages over other forms of raising revenue. They are practically the only noncoercive source of revenue, the administrative burden is low, taxpayers' rights and privacy are not infringed upon by overzealous bureaucrats, and costs are not hidden. The major drawback is that lotteries do not raise enough revenue by themselves to fully fuel a large welfare state. But that is not the fault of the lottery. If government services were limited to the protection of life, liberty and property, and user fees were implemented to pay for some of these services, there might not be any need for coercive forms of taxation.

VI.

SPECIAL PROBLEMS OF RAISING REVENUE IN EMERGING ECONOMIES

All countries face some problems in raising taxes. But countries that are in the process of converting to a market economy face some special problems. This section discusses some of those problems.

A. Lack of a Price System

Under central planning, the tax structure is much different because all or most of the factors of production are owned by the government. Rather than having definite rules to transfer a portion of profits to the State, based on the excess of revenue over expenses, some central authority merely decides, often by edict, how much to transfer and where.

Centrally planned economies are further hindered²⁶⁷ by the fact that there is no price system. Prices are determined by some central authority rather than the market and State enterprises are not able to determine with any degree of accuracy whether they have made an economic profit or incurred a loss.²⁶⁸

267. All centrally planned economies are hindered because the structure of the system prevents market signals from informing people how resources should be utilized.

268. The economic calculation debate discussed this phenomenon in depth during the 1920s and 1930s. For discussions on this point, see LUDWIG VON MISES, *SOCIALISM: AN ECONOMIC AND SOCIOLOGICAL ANALYSIS* 128-50, 516-21 (J. Kahane trans., 1936 & 1951), first published in German as *DIE GEMEINWIRTSCHAFT: UNTERSUCHUNGEN ÜBER DEN SOZIALISMUS* (1922); Ludwig von Mises, *Neue Beiträge zum Problem der sozialistischen Wirtschaftsrechnung* (New Contributions to the Problem of Socialist Economic Calculation), 51 *ARCHIV FÜR SOZIALWISSENSCHAFT UND SOZIALPOLITIK* 488-500 (1923), partially reprinted in English at 516-21 of Mises' *SOCIALISM*; Ludwig von

Their whole accounting system would have to be revised in order to allow them to calculate what their profits are. Only then could they determine what their tax liability is, since, in a market-based income tax system, tax liability is computed as a percentage of the excess of revenue over expenses.

B. Adopting Western Systems

There is a tendency for less developed countries (LDCs) and nations emerging from socialist planning to mimic western tax systems.²⁶⁹ For example, virtually all LDCs have adopted some kind of individual and corporate income tax.²⁷⁰ Where the LDC is a former colony, there has been a tendency to adopt a system similar to that of the former colony's "benefactor."²⁷¹

Such a copycat approach is not all bad. After all, it makes no sense to reinvent the proverbial wheel. However, some European economists have taken the position that central and eastern European countries "must" adopt western personal and corporate income tax, sales tax and social security tax systems and the basic principles that go with them.²⁷² Even if there is some adaptation for local conditions, there are dangers in blindly adopting western tax systems.

One such problem is that western systems are far from perfect. There are many suboptimum components of all western tax systems; blindly adopting such systems results in taking the bad along with the good. At the very least, countries that want to adopt a western tax system should first examine closely what they are adopting. Much empirical evidence suggests that there are better ways to collect taxes than what is currently being done in the west.

One of the advantages of converting from a centrally planned system to a market system is that the converting country need not make the same mistakes that western countries have made. With careful study and analysis, LDC's can avoid most of the western mistakes that would place them at a competitive advantage with the west. If emerging economies first closely examine what it is they want to adopt, they can take the good parts of western systems without taking the bad parts.

Mises, *Neue Schriften zum Problem der sozialistischen Wirtschaftsrechnung* (New Papers on the Problem of Economic Calculation under Socialism), 60 ARCHIV FÜR SOZIALWISSENSCHAFT UND SOZIALPOLITIK 187-190 (1928); COLLECTIVIST ECONOMIC PLANNING: CRITICAL STUDIES OF THE POSSIBILITIES OF SOCIALISM (F.A. Hayek ed., 1935; 1975); Oskar Lange, *On the Economic Theory of Socialism*, 4 REV. ECON. STUD., Oct. 1936, at 53-71, and Feb. 1937, at 123-42, reprinted in ON THE ECONOMIC THEORY OF SOCIALISM 55-143 (1938); TRYGVE J.B. HOFF, ECONOMIC CALCULATION IN THE SOCIALIST SOCIETY (1938, 1949 & 1981).

269. Poland has even gone so far as to invite the U.S. Internal Revenue Service to Poland to give Polish tax agents instruction on how to collect taxes. For more on this point, see Stephen Engelberg, *Polish Tax Agents Learn From I.R.S.*, N. Y. TIMES, Mar. 26, 1992, at D1.

270. CHARLES E. McLURE, JR., TAX POLICY LESSONS FOR LDCs AND EASTERN EUROPE 5 (1992). For some statistical data on the various taxes that developed and developing countries impose, as a percentage of gross national product (GNP), see Robin Burgess & Nicholas Stern, *Taxation and Development*, 31 J. ECON. LIT. app. 762, tbl. 2 (1993).

271. McLURE, *supra* note 270, at 5-6.

272. P. Jurkovic, *Designing a Tax System to Promote Structural Change*, in THE ROLE OF TAX REFORM IN CENTRAL AND EASTERN EUROPEAN ECONOMIES 45, 48 (1991).

C. Consumption Taxes

Another problem, which Charles McLure, among others, has pointed out, is that the sound tax policy of a developed country may not fit the economic landscape of an emerging economy. Moreover, it may not be administrable.²⁷³ McLure recommends a simplified consumption tax rather than an income tax because it is easier for an LDC to administer.

However, consumption taxes can pose problems. Some centrally planned economies, for example, sometimes use the turnover tax, a form of consumption tax, to reduce demand. When consumer goods are in short supply, officials raise the turnover tax rate to dampen demand—as the price system would do in a market economy—and shorten the lines that would otherwise result as an excess of consumers try to get the few items that are available.²⁷⁴ Another problem that centrally planned economies have had with turnover taxes is that there can be thousands of rates, which add to the administrative burden.²⁷⁵ The solution to this problem, of course, would be to reduce the number of rates—ideally to one—and to keep the rate constant rather than trying to manipulate the rate to perform as a price system would. This problem will disappear if the government moves toward the market system since the price system will allocate goods that are in short supply.

Bulgaria at one time had about 2,000 different turnover tax rates, but has reduced that number to a mere 43 and has plans to reduce that to 4.²⁷⁶ Romania has reduced the number of rates to 20. There have been suggestions to reduce the turnover tax, or to replace it with a VAT, not only because the administration is easier, but also to bring the tax systems of the emerging market economies of Eastern and Central Europe more in line with the European Union.²⁷⁷ However, such a change is not necessary. The turnover tax can be greatly simplified by reducing the number of rates to one. Furthermore, the VAT is far from simple, especially the way it is evolving in Western countries, and it is not something that should be emulated by emerging economies that are less able to administer the complexity of such systems. The VAT also suffers from several other defects, as discussed above.

D. Inflation

Another reason why an income tax may not fit neatly into the public finance system of an LDC is that many LDCs have high inflation.²⁷⁸ Income and profits become difficult to measure when prices change rapidly. With a high inflation rate, what looks like a high paper profit may actually be a loss. If

273. For an elaboration on this point, see McLURE, *supra* note 270.

274. Tanzi, *Tax Reform, in THE ROLE OF TAX REFORM, supra* note 140, at 19, 20.

275. *Id.*

276. *Id.* at 24.

277. *Id.*

278. Charles E. McLure, Jr., *Lessons for LDCs of U.S. Income Tax Reform, in TAX REFORM IN DEVELOPING COUNTRIES* 347-90 (1989); McLURE, *supra* note 270, at 6.

profits are taxed in such an environment, the effective tax rate may actually be more than 100%.

For example, let's say that some company in a country with a high rate of inflation purchases widgets at wholesale for 1,000 pesos in January. In October, it sells the widgets for 4,000 pesos. On paper, it looks like the company made a 3,000 peso profit. If the tax rate is 40%, the company incurs a tax liability of 1,200 pesos (3,000 x 40%). However, if inflation increases the cost the company must pay to 3,500 pesos to buy similar widgets at wholesale in October, the actual economic profit is only 500 pesos (4,000 peso selling price - 3,500 peso October value). Here the company pays a tax of more than 100% because it incurs a tax liability of 1,200 pesos when its actual economic profit was only 500 pesos. A tax that is based on consumption instead of income would avoid this problem.

Of course, not all emerging economies have high inflation. Those that do can cure the problem by stopping the expansion of the money supply.²⁷⁹ The inflation factor could be taken into account by indexing, but, for a number of reasons, doing so would add tremendous complexity to the system. For one thing, massive and detailed records would have to be kept. Also, prices for different commodities rise at different rates, so using a general index to convert historical costs to current costs is only an approximation. Industries in which prices rise at a faster than average rate would be harmed by the use of a general index and industries in which prices rise at a below-average rate would be helped, in relative terms. Of course, this defect could be cured by using industry indexes instead of a general index; however, that would add further complexity to the system.

E. Evasion

For economies that were formerly centrally planned, tax evasion is a new phenomenon. There was very little evasion when all enterprises were owned by the State. Payments between enterprises or between enterprises and the government were often made by credit transfers and liability for the turnover taxes

279. There has been a long-standing debate as to what causes inflation and how to reduce or stop it. Monetary theorists take the position that inflation is directly related to the increase in the supply of money. The cure, therefore, lies in controlling the rate of increase. For exponents of this view, see MILTON FRIEDMAN, *A PROGRAM FOR MONETARY STABILITY* (1959); MILTON FRIEDMAN, *DOLLARS AND DEFICITS* 21-71 (1968); HANS SENNHOLZ, *MONEY AND FREEDOM* (1985); LUDWIG VON MISES, *THE THEORY OF MONEY AND CREDIT* (1971), first published in German as *THEORIE DES GELDES UND DER UMLAUFSMITTEL* (1912). Some prominent economists go even farther and advocate the privatization of the money supply. For example, see F.A. HAYEK, *DENATIONALIZATION OF MONEY—THE ARGUMENT REFINED* (3rd ed. 1990). Other prominent economists take the (Keynesian) position that inflation is caused either by an increase in aggregate demand (demand-pull inflation) or by an increase in aggregate costs (cost-push inflation). For an explanation of the Keynesian views, see any economic textbook. Although the Keynesian view has been refuted for generations, it is still considered valid in many policymaking circles. For a refutation of the Keynesian position, see HENRY HAZLITT, *THE INFLATION CRISIS, AND HOW TO RESOLVE IT* (1978). A detailed discussion of this point is beyond the scope of this paper.

could be calculated by the state bank very easily.²⁸⁰ There was little opportunity or incentive to evade a tax because everything belonged to the government anyway.

But in a private property regime, where the most popular forms of taxation are considered a form of property confiscation, the incentive for evasion is great. Economies that are converting to a market system do not have the administrative apparatus in place to prevent the evasion that will inevitably take place. Where prices are allowed to move freely and where payments can be made by cash rather than by credits to the state bank, the amount of tax owed cannot be determined with any degree of accuracy by the taxing authority.

F. The Anti-Capitalistic Mentality

The anti-capitalistic mentality, the view that capitalism and capitalists are somehow evil, will be held by some members of some economy, even western ones.²⁸¹ But the view is more prevalent in the former communist countries where people have been inculcated with the idea that self-interest and private property are evil. Sometimes, these views are incorporated into the tax system. In Russia, for example, an excess profits tax is levied on companies whose profits are above the national average for the industry.²⁸² Such taxes seriously dampen entrepreneur's incentives to provide the goods and services that consumers want most. If a company has high profits, it is fulfilling consumer needs better than other companies that have average or below-average profits. To punish such a company for its success by taxing its profits at a higher rate is unfair to the company's owners and damages consumers since these companies will be less eager to supply a market if there is little or no reward for doing so. Also, the tax itself hurts consumers because the tax presumably raises prices unless the producer absorbs 100% of the tax.

A tax system that incorporates punitive tax rules will retard economic growth because such rules destroy the incentive to create wealth and produce goods and services, not to mention that it will hinder the economy in today's global climate. The urge to incorporate punitive tax measures into the system must be resisted. They serve no useful purpose; they merely confiscate large amounts of property from the most productive members of society.

G. The Welfare State Mentality

The welfare state mentality, the view that government should be the provider of a wide range of services from cradle to grave, exists in all countries to some extent. It exists to a greater extent in countries like Sweden, Denmark,

280. Tanzi, *Tax Reform*, in *THE ROLE OF TAX REFORM*, *supra* note 140, at 19, 20.

281. For more on this phenomenon, see LUDWIG VON MISES, *THE ANTI-CAPITALISTIC MENTALITY* (1956); ROBERT SHEAFFER, *RESENTMENT AGAINST ACHIEVEMENT: UNDERSTANDING THE ASSAULT UPON ABILITY* (1988); HELMUT SCHOECK, *ENVY: A THEORY OF SOCIAL BEHAVIOUR* (1966).

282. Tanzi, *Tax Reform*, in *THE ROLE OF TAX REFORM*, *supra* note 140, at 19, 24.

Germany and Austria and to a lesser extent in the United States. It also exists in the former socialist countries.

The problem with the welfare state mentality is that people tend to look to government for solutions to their problems rather than to themselves. Welfare states require vast amounts of money to operate. People who live in such states must be prepared to pay a large percentage of their income in taxes, whether in the form of an income tax, VAT, retail consumption tax, property tax, or social security tax. Former socialist countries, especially those that have been socialist for a few generations, have a special problem breaking away from this worldview because it is the only view that many of their citizens have ever been exposed to. It seems natural for them to look to government because, until recently, there was little or no private enterprise or markets to provide what they needed. The tax burden can decrease only if government cuts back on the extent of services it provides. Thus, the view must change if the goal of establishing a system of low taxes is to be maintained. This will require changing the habits of people, a concededly daunting task.

VII. THE LATVIAN TAX SYSTEM

A. Overview

The Republic of Latvia has had its own tax system since 1991.²⁸³ This system includes a profit tax,²⁸⁴ a personal income tax,²⁸⁵ a property tax,²⁸⁶ a land tax,²⁸⁷ a natural resource tax,²⁸⁸ a turnover tax,²⁸⁹ an excise tax,²⁹⁰ a social tax,²⁹¹ and customs duties.²⁹²

The coordination and licensing of lotteries in the Republic of Latvia is the task of the Department of Bonds at the Ministry of Finance. At present, the Department is working on the conception of a consolidated lottery system in

283. An overview of this system may be found in GUIDE FOR FOREIGN INVESTORS, REPUBLIC OF LATVIA, issued by the Ministry of Economic Reform (U. Vitolins & A. Licpins eds., 1993) [hereinafter GUIDE FOR FOREIGN INVESTORS]. However, the system outlined in the *Guide* has been changed somewhat by subsequent legislation.

284. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 36.

285. *Id.* at 38.

286. *Id.*

287. *Id.* at 39.

288. *Id.*

289. *Id.* at 40.

290. *Id.* at 40-41.

291. *Id.* at 41.

292. Customs duties were not mentioned in GUIDE FOR FOREIGN INVESTORS, *supra* note 285. I learned about this tax from Jevgenijs Ostaskovs, Director, Tax Control Department, State Revenue Service, Latvijas Republikas Finanšu Ministrija, Valsts Ienemumu Dienests. I am grateful to Mr. Ostaskovs for much of the current tax data referred to in this paper. Hereinafter, where the source is Mr. Ostaskovs, it will be cited as Latvian Finance Ministry. The information in this paper pertaining to the Latvian tax system is believed to be accurate as of March 24, 1994. Some of the information received from the Latvian Finance Ministry was also confirmed by Dr. Raita Karnite, Director, Institute of Economics, Latvian Academy of Sciences. My thanks go to her as well for her assistance.

Latvia in cooperation with some other countries. The draft laws On Lotteries and Gambling and On the Taxation of Lotteries and Gambling are prepared for the approval of the Cabinet of Ministers and Parliament. At the moment, the state company "Latloto" and the Savings Bank are organizing lotteries in Latvia.²⁹³

The revenue received from the different taxes collected in Latvia in 1993 (in units of thousands of Lats, the Latvian monetary unit) was as follows:²⁹⁴

Turnover tax (VAT)	95,303
Profit tax	107,108
Excise tax	12,104
Personal income tax	55,274
Social tax	162,783
Natural resource tax	1,159
Customs duties	20,644

The tax system's main purposes are to:

- Provide the State with the financial resources necessary for the implementation of social and economic tasks,
- Provide the local government with a strong financial base, and
- Create favorable conditions for the production and development of different forms of property and different entrepreneurial associations.²⁹⁵

These are all worthy goals, goals that any tax system should strive to achieve. But some ways of achieving these goals are better than others. One aim of this paper is to discuss and evaluate the major alternative methods that are available to Latvia and other emerging economies in their quest for a good system of public finance.

The next section is a review of the various components of the Latvian tax system.

B. The Profit Tax

The profit tax taxes all profit including profit derived from foreign economic activity of enterprises operating within Latvia.²⁹⁶ Natural and legal persons, including the state and self-governing institutions that perform entrepreneurial activities, are subject to this tax.²⁹⁷ The rate varies depending on the entity being taxed and the nature of the economic activity engaged in.²⁹⁸ There is no capital gains tax if the buyer is a natural person.²⁹⁹ But if the buyer is an entity, the gain would be included into taxable income and the profit would

293. Latvian Finance Ministry, *supra* note 294.

294. *Id.*

295. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 36.

296. *Id.*

297. *Id.*

298. *Id.*

299. *Id.*

be taxed as the difference between income and costs.³⁰⁰ The tax rates for the profits tax are as follows:

- 45% for enterprises and companies that deal with banking, the purchase and sale of foreign currency, insurance services and trade, except the sale of self-produced production;³⁰¹
- 35% for enterprises "in property of which is share of state or local government's property";³⁰² and
- 25% for enterprise owners who use only the property of physical persons.³⁰³
- 65% on income derived from casinos, lotteries (except charitable lotteries and the Latvian Republic State lottery) and gambling operations.³⁰⁴ To compute the tax liability, expenditures (other than labor costs) are to be subtracted from income. Thus, the tax rate is actually higher than 65% because labor costs cannot be deducted to arrive at the taxable base.

The turnover tax (VAT) and excise tax can be deducted before arriving at taxable income.³⁰⁵ There are a number of exceptions to the general rules. The main ones are as follows:

- In the first three years after registration, subject to exceptions, the taxable profit of the enterprise can be reduced "by the amount of expenses spent for investments in the reconstruction of the basic funds" and in expanding the enterprise's production as well as for interest payments on long-term bank loans, provided the expenses are paid from retained profits.³⁰⁶ This exception does not apply to enterprises that are formed from dissolved or reorganized enterprises.³⁰⁷ For enterprises that are dissolved before their third year of operation, the profit tax is computed for all years of operation.³⁰⁸
- Certain charitable, health and handicapped organizations are exempt from the profit tax.³⁰⁹
- Profits derived from agricultural activity, the processing of self-produced agricultural products and the production and restoration of machinery are tax-free.³¹⁰
- Taxable income can be reduced by 285% of the expenditures made as donations or gifts to cultural, health, educational, scientific and charitable organizations, foundations or programs, or the development of production in the individual farm sector.³¹¹ This reduction is limited to 15% of the total amount of profit subject to tax.³¹²
- Profit subject to tax can be reduced by 100% of the amount spent for the development of sports, the organizing of sporting events, the construction of new sporting facilities, the repair or maintenance of existing sporting facilities, or

300. Latvian Finance Ministry, *supra* note 294.

301. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 36.

302. *Id.*

303. *Id.*

304. *Id.* at 37.

305. Jevgēnijs Ostaskovs & Raimonds Markēvics, *Latvia Enacts Changes to Profits Tax, VAT, and Excise Tax*, 5 TAX NOTES INT'L 486, 492 (1992).

306. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 37. Before its repeal in 1992, there was a rule that exempted new enterprises from the profit tax for the first two years. *Id.* at 491.

307. *Id.* at 37.

308. *Id.*

309. *Id.*

310. *Id.*

311. *Id.*

312. *Id.*

the purchase of sporting equipment.³¹³ Taxable income can be reduced by 200% of the amount expended for the financing of internationally recognized sports federations. Expenditures qualifying for this tax benefit are not to exceed 15% of the total profit subject to tax.³¹⁴

Exemptions were reduced and tax rates were raised in 1992 because of pressure from the International Monetary Fund to have a balanced budget.³¹⁵ The rates are too high, at least in the case of the 65%, 45% and 35% rates. High rates will make these enterprises less competitive internationally, retard their growth and encourage tax evasion. Moreover, differential rates lead to unnecessary complication. Some enterprises may be engaged in several kinds of activity, which may be taxed at different rates, requiring detailed and complicated record-keeping. There may be classification problems as enterprises attempt to classify their activity so that it falls into the lower tax bracket whenever there is any doubt as to the nature of the economic activity.

There is also a question of fairness since taxpayers are not treated equally. Although the government presumably provides equal services for all, some are taxed at a higher rate than others, which means that some taxpayers are exploited more than others. The rate structure is based on the ability-to-pay principle rather than the cost-benefit principle; this is morally bankrupt. Differential rates also provide incentives for enterprises to put their resources into certain favored activities (those with lower tax rates) and to remove resources from disfavored forms of activity (those with higher rates), which results in the misallocation of economic resources, thus retarding economic growth. The activities taxed at the highest rate—banking, insurance and trade—are ones that are underdeveloped and thus most in need of government support.³¹⁶ Yet these activities are discouraged by the relatively high tax rate imposed, which is counterproductive.

Any kind of tax on income dampens the incentive to enter into productive activity. Because tax liability for expenditures is reduced to a greater extent when rates are high rather than when they are low, the higher the tax rate, the lower the incentive to cut costs. One positive aspect of the Latvian profit tax, relatively speaking, is that there is only one rate for each type of activity. Hav-

313. *Id.*

314. *Id.*

315. Ostaskovs & Markēvics, *Latvia Enacts Changes to Profits Tax, VAT, and Excise Tax*, in *TAX NOTES INT'L*, *supra* note 307, at 491.

316. The problem of industrial policy also arises here. It is questionable whether government should deliberately aim at supporting any particular industry or form of economic activity because such support causes economic resources to be shifted into the supported activities and away from other activities. The allocation of resources under industrial policy is necessarily different than that which would occur under a free market. Otherwise, there would be no need for industrial policy. The fatal flaw with any industrial policy is that bureaucrats are the ones who determine how resources are allocated, not investors. And the history of industrial policy is a history of misallocation of resources, as bureaucrats tend to choose which activities to support based on political pressure rather than on sound economic judgment. The industrial policy literature is full of examples where resources are misallocated, but exploring this issue in any depth is beyond the scope of this paper. For documentation of this point, see MCKENZIE, *supra* note 31; BURTON, *supra* note 31; PALDA, *supra* note 31. The Fall 1984 issue of *THE CATO JOURNAL* (Vol.4, No.2) is also devoted to this topic.

ing a graduated rate system would cause further distortion and would result in further complexity.

The tax base is broadened because government enterprises are also subject to the tax. This makes it possible to generate the needed funds by charging a lower rate than would otherwise be possible. It also places government enterprises on an equal footing with private enterprises. The alternative—taxing private enterprises while allowing state enterprises to operate free of tax—would place the private sector in a disadvantaged position since these private enterprises would have to compete with enterprises that do not have the same tax burden. Of course, a more fundamental question might be asked—what are the government enterprises doing providing goods and services that compete with the private sector in the first place? The private sector can do these things more efficiently than the state sector. The answer to this question would take us beyond the scope of this paper.³¹⁷

Another problem with the present profit tax policy is the effect that taxing foreign source income might have on capital investment and economic growth. If economic growth and capital accumulation are the primary goals, then there should be no taxation of foreign-source income. Taxing such income gives enterprises an incentive to locate outside of Latvia. If such income must be taxed, some approaches have proven to be better than others. The approach used in the United States,³¹⁸ for example, is more damaging to its international competitiveness than are the approaches used in such places as the Netherlands, Japan and Germany.³¹⁹

Taxing foreign source income also raises the issue of fairness. For example, if a Latvian company derives some income from a facility in Germany, the Latvian company gets taxed on that income; however, the Latvian government does not provide any services for the German operation. If any government provides services to the German facility it is the government of Germany, which probably also taxes the Latvian facility located in Germany. It seems grossly unfair that a government should assess a tax against a facility that is not even in the country and for which no services of the taxing authority can be had.

The right to deduct certain capital expenditures and interest expenses does not apply to enterprises that are successor enterprises. Thus, there is no incen-

317. There is ample evidence to show that the private sector can do just about anything more efficiently than the State. For examples, see SAVAS, *supra* note 3; POOLE, *supra* note 3; BENNETT & JOHNSON, *supra* note 3; FITZGERALD, *supra* note 3; PRIVATIZATION, *supra* note 3; NEW YORK STATE SENATE ADVISORY COMMISSION ON PRIVATIZATION, *PRIVATIZATION FOR NEW YORK: COMPETING FOR THE FUTURE* (1992).

318. The U.S. tax rules tax a domestic company's foreign source income, subject to certain forms of relief, such as the option of taking a deduction or a foreign tax credit. Other countries do not have such a rule. So a California company that has a branch in Germany is taxed on the German income by the United States, but a German company that has a branch in California is not taxed by Germany on its California income.

319. For a detailed discussion of this point, see Joel Slemrod, *Competitive Advantage and the Optimal Tax Treatment of the Foreign-Source Income of Multinationals: The Case of the United States and Japan*, 9 AM. J. TAX POL'Y 113 (1991).

tive to dissolve an enterprise just to take advantage of the special tax break that could otherwise be had by forming a new enterprise out of the remains of a former, recently dissolved enterprise. But this three-year rule places older enterprises at a competitive disadvantage over more recently formed enterprises because older enterprises do not qualify for these tax breaks. A good case can be made that interest expenses should be deductible by all enterprises since deductibility provides an incentive to expand, thus creating jobs and fostering economic growth.³²⁰ Fairness is also an issue. Why should some enterprises (newly formed ones) be treated better than enterprises that have been in existence for more than three years? And why should any enterprise not be able to deduct all legitimate expenses (such as interest costs) in arriving at taxable income? A more equitable approach would be to either allow all enterprises to deduct all of the expenditures outlined in this exception regardless of when the enterprise first registered or to allow no exceptions.

The policy of exempting certain agricultural activity and the production and restoration of machinery is really a form of subsidy for these types of activity. It provides incentives to go into (and remain in) these businesses. This policy reduces the tax base making it necessary to increase the amount of taxes that other taxpayers must pay because the subsidy recipients do not pay "their fair share."³²¹

A few other points are worth making as well. The agricultural industry and the machine restoration business are not growth industries. If anything, they are declining industries. By subsidizing these special interests, resources are prevented from shifting to more productive uses. Also, the fact that the government would subsidize one industry opens the door for other special interests to demand subsidies or special treatment for themselves, thus causing resources to be allocated even more inefficiently, not to mention adding complexity to the tax law. This kind of tax policy retards economic growth and should be abandoned.

The U.S. tax code also provides a tax incentive to contribute to certain kinds of charitable activities.³²² The Latvian approach is less complex than the U.S. rule and provides more of an incentive because it allows the contributor to reduce taxable expenditures by 285% of the contributed amount, subject to certain limitations.³²³ One positive aspect of this exception is that it will encourage the expansion of philanthropy. It will make it easier to privatize certain enterprises such as cultural, health, scientific and educational institutions because this tax rule will open up sources of funding for these organizations that were not

320. Of course, allowing interest expenses to be deducted results in favoring debt financing over equity financing. But this favoritism could easily be overcome by also allowing dividends to be deducted from taxable income.

321. Of course, if taxation is regarded as theft, everyone's fair share equals zero, and the fact that some people must pay more just because some individuals or groups are able to escape from the clutches of the thief is not something that can be regarded as unfair.

322. I.R.C. § 170 (1995).

323. *GUIDE FOR FOREIGN INVESTORS*, *supra* note 285, at 37.

previously available. One disadvantage of this policy is that it might cause some resources to be diverted to less productive uses.

This charitable contribution exception actually gives Latvian enterprises an incentive to squander resources because doing so will reduce their tax liability. For example, if a Latvian enterprise decides to contribute 100 lats to an educational organization, it reduces its taxable income by 285 lats. If it is in the 65% tax category, it can reduce its tax liability by 185.25 lats, or 65% of 285 lats. For every 100 lats contributed, tax liability is reduced by 185.25 lats. Thus, it makes economic sense to divert some enterprise resources to such charitable or educational enterprises because after-tax profits actually can increase.

Given this scenario, contributing a portion of profits to charity makes good business sense. However, such expenditures retard the growth of the profit-seeking enterprise because these funds cannot be used to invest in expansion (although tax savings that result from making such contributions can be used for this purpose).

C. The Personal Income Tax

Employment income and other income that is derived in Latvia and not subject to the profit tax is subject to the income tax. The tax structure is progressive. Until the end of 1993, the rates were 15%, 20%, 25%, 30% and 35%, depending on income level.³²⁴ The legislature then passed a new tax law that changed the rates to 25% and 35%³²⁵ as of January 1, 1994.³²⁶ The tax rate is 10%³²⁷ on dividends, income from bank and credit institution deposits, and agricultural income.³²⁸ Taxes from income in foreign currency must be paid in foreign currency at a rate of 17%.³²⁹ There are exemptions for individuals who earn less than the minimum wage, for the handicapped, and for those on pensions, scholarships, and certain other items.³³⁰

Unlike the individual income tax in the United States, social security taxes are deductible in arriving at taxable income³³¹ and education³³² and medical expenses³³³ are fully deductible, subject to certain limits.³³⁴ The new law also

324. *Id.* at 38.

325. Law on Resident Income Tax, art. 15, prepared by the Supreme Council Economics Committee, Republic of Latvia, 1993. Hereinafter referred to as Law on Resident Income Tax.

326. Latvian Finance Ministry.

327. Law on Resident Income Tax, art. 15.3.

328. *Id.* art. 8.4.

329. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 38.

330. *Id.*

331. Law on Resident Income Tax, art. 10.3.

332. *Id.* art. 10.4.

333. *Id.* art. 10.5.

334. *Id.* art. 10.4, 10.5.

allows income averaging,³³⁵ which was abolished in the United States some years ago.³³⁶ Also, alimony is not taxable to the recipient.³³⁷

This tax is based on the ability-to-pay principle which, as previously mentioned, is flawed because it views taxpayers as targets for exploitation rather than as masters or customers to be served. Graduated tax rates also dampen the incentive to work and create wealth, and adds unnecessary complication to the tax code. The exemptions provide relief for some taxpayers but also open the door for other special interests to demand exemptions for themselves, which will add further complexity to the tax law in the future.

D. *The Property Tax*

The Latvian property tax taxes assets and unfinished buildings located in Latvia.³³⁸ Taxpayers subject to the tax include both natural persons and legal entities.³³⁹ The tax rate ranges from 0.5% to 4%. No property tax is imposed on: property having less than a certain value;³⁴⁰ homes, if not used for entrepreneurial activities; property used for agricultural activities; property maintained by the budget allocations; objects of social services; property of religious organizations, national cultural societies and other public organizations; dwelling houses and property used in municipal services; and cultural monuments.³⁴¹

One of the major differences between the Latvian property tax and the U.S. property tax is that the Latvian tax excludes personal residences. However, the top Latvian tax rate—4%—is higher than most U.S. property tax rates. This could create a hardship on certain property owners whose property is not productive enough to generate sufficient income to pay the tax and to earn a reasonable profit.

E. *The Land Tax*

Latvia imposes a land tax on taxpayers, both natural and legal, who have been allocated land for their use.³⁴² The tax is not levied on: land used for collective transportation routes; lines of communication and strips of land allocated to those communications functions; land that has been banned from com-

335. *Id.* art. 30.1. Income averaging allows individuals who have fluctuations in income to spread it out over several years. For example, if income was \$10,000 last year and \$90,000 this year, you can pretend that it was \$50,000 in each year. Averaging allows a break in taxes if rates are graduated because high income years push you into a higher tax bracket.

336. Section 1302 of the Internal Revenue Code of 1954 was repealed by the Tax Reform Act of 1986, see TRA § 141, effective for tax years starting after 1986.

337. Law of Resident Income Tax art. 9.9.

338. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 38.

339. *Id.*

340. In GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 38, it states this threshold amount to be 30,000 roubles. However, the rouble has been replaced by the lat as the official currency. When Latvia was operating under a dual currency system—roubles and lat—the exchange rate was 200 roubles to one lat.

341. *Id.*

342. *Id.* at 39.

mercial use; land used for local government institutions and residences; individual farms up to the first five years, if the starting conditions are unsatisfactory.³⁴³

Local governments may either increase or reduce the tax rate on specific tracts of land. The tax can be reduced: for natural disasters and acts of God; in cases where the scope of commercial activity on the land is limited; if the users of the land are either retired, handicapped or poor; or if the users are religious or charitable organizations.³⁴⁴

One difference between the Latvian and U.S. land tax is that, in the United States, the tax is imposed on the owner of the land regardless of who uses it; in Latvia, the tax is imposed on the user.³⁴⁵ Another difference is that Latvia does not tax residential housing³⁴⁶ while the United States does. One similarity is that the tax in both the United States and Latvia can be reduced for retired persons.³⁴⁷ Additionally, in the United States, land owned by religious or charitable organizations is generally exempt from tax.

F. The Natural Resource Tax

The natural resource tax is assessed for the utilization of natural resources and for environmental pollution, within certain limits.³⁴⁸ There are also fines for pollution and utilization that exceeds the limits.³⁴⁹ Those subject to the tax include all legal entities and physical persons who utilize natural resources and who have a permit or license.

The Environmental Protection Committee of the Republic of Latvia determines the types of environmental pollution and the list of natural resources that are taxable, as well as the respective limits of pollution and utilization of resources.³⁵⁰ Its actions are approved by the Supreme Council of the Republic of Latvia.

In the United States, the approach to natural resources is much different. Natural resources that are privately owned are not subject to a natural resource tax although they are usually subject to a local property tax. Natural resources that are owned by government entities and used by private parties are not taxed, but the private parties generally pay for their use in the form of user fees.

Private parties, and sometimes governmental entities, can be and are in some cases fined for polluting.³⁵¹ In other cases, they acquire pollution permits

343. *Id.*

344. *Id.*

345. *Id.*

346. *Id.*

347. *Id.*

348. *Id.*

349. *Id.*

350. *Id.*

351. *Id.*

that grant them the right to pollute within certain limits. These pollution permits or emission rights are sometimes transferable.³⁵²

G. *The Turnover Tax*

The Latvian turnover tax is imposed on goods, services, and work sold.³⁵³ However, the exchange of goods does not trigger the tax if the seller is not an enterprise or a company.³⁵⁴ Those subjected to the tax include enterprises that perform entrepreneurial activity and nonprofit organizations that sell or import goods, services, and works.³⁵⁵

A 6% rate was imposed on feed and feed products; cattle and poultry, meat and meat products; milk and milk products; and fish and fish products until late 1993.³⁵⁶ Subsequent legislation raised the rate to 12% as of November 1, 1993.³⁵⁷ Until late 1993, a 12% rate was applied to other taxable transfers.³⁵⁸ Exports are exempt from tax, as are medical remedies and services, public catering organized by employers for employees, as well as public catering in educational, medical establishments, reformatories and social maintenance organizations, theater, cinema (except video shows), circus performances and concerts, museum visits, exhibitions, zoological and botanical gardens, afternoon activities devoted to children or connected with a charitable purpose, sporting events or amateur performances, the lease of feature and documentary films, bank services, insurance services, transit conveyance, mass media registered with the Republic of Latvia, and land leases.³⁵⁹ That rate has since been raised to 18%.³⁶⁰ There was a temporary rate of 10% expiring on May 31, 1994 imposed on grain and grain products, meat and meat products, milk and dairy products and on fish and fish products.³⁶¹

When the 6% and 12% rates became effective, on October 1, 1992, it was estimated that the result would be a 7.8% reduction in the standard of living.³⁶²

352. For more on this point, see BRUCE YANDLE, NATIONAL CHAMBER FOUND., A PRIMER ON MARKETABLE POLLUTION PERMITS (1991); Robert W. Hahn & Gordon L. Hester, *Where Did All the Markets Go? An Analysis of EPA's Emissions Trading Program*, 6 YALE J. REG. 109 (1989); Robert W. Hahn & Gordon L. Hester, *Marketable Permits: Lessons for Theory and Practice*, 16 ECOLOGY L. Q. 361 (1989); Jorge A. del Calvo y Gonzalez, *Markets in Air: Problems and Prospects of Controlled Trading*, 5 HARV. ENVTL L. REV. 377 (1981); Michael Shapiro & Ellen Warhit, *Marketable Permits: The Case of Chlorofluorocarbons*, 23 NAT. RESOURCES J. 577 (1983); Barry S. Read, *The Permit Fee Program of Title V of The Clean Air Act of 1990: Developing State Fee Programs*, 44 SW. L. J. 1553 (1991); Yvonne F. Lindgren, *The Emissions Trading Policy: Smoke on the Horizon for Takings Clause Claimants*, 18 HASTINGS CONST. L. Q. 667 (1991).

353. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 40

354. *Id.*

355. *Id.*

356. *Id.*

357. Latvian Institute of Economics and Latvian Finance Ministry.

358. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 40.

359. *Id.*

360. Latvian Institute of Economics and Latvian Finance Ministry.

361. Latvian Finance Ministry.

362. Ostaskovs & Markēvics, *Latvia Enacts Changes to Profits Tax, VAT, and Excise Tax*, in TAX NOTES INT'L, *supra* note 307, at 492.

The 1993 rate increase is likely to further reduce the standard of living, although to the author's knowledge, no studies have yet been conducted to estimate the extent of the decline.

The U.S. federal government does not impose a transfer tax although transfer taxes—called sales taxes—are commonly used to raise revenue at the state and local level. The tax rate is never as high as 12% or 18%, although the rate does exceed 5% or 6% in some jurisdictions. Essential items such as food and medicine are usually exempt from the sales tax.

H. The Excise Tax

Sellers or importers of certain goods are subject to the excise tax.³⁶³ Tax rates are as follows:³⁶⁴

- 300% on ethyl alcohol for sale in retail trade;
- 150% on liquor products with content of spirit over 25%, cognac, drinks of cognac, whisky, rum, gin, and Riga Black Balsam;
- 200% on other alcoholic beverages with a spirit content over 25%;
- 30% on champagne and wine;
- 100% for liquor and other alcohol with a spirit content of between 8% and 25%;
- 100% on tobacco articles;
- 30% on extra-class perfume; gold items and other precious metals; jewelry with diamonds; precious stones and semi-precious stones.

A 30% tax is added to the sales price or value of the goods listed above if they are imported, and it is added to raw spirits if these goods are used for the production of other goods not listed above.³⁶⁵ The excise tax is not imposed on: exports; ethyl alcohol for medical use, scientific works and the pharmaceutical industry; goods provided for the production of goods mentioned in the Law.³⁶⁶

The tax rates imposed in Latvia are, in many cases, much higher than the rates imposed by the federal and state governments in the United States. And, the range of items upon which the tax is imposed is smaller. In the United States, excise taxes are imposed on alcohol and tobacco products as well as on automobile tires, gasoline, and a number of other items. The Latvian Parliament debated whether an excise tax should be imposed on fuel,³⁶⁷ but so far has decided to exempt fuel from the tax. The debate on rates for alcoholic beverages degenerated into an argument about which drinks cause the greatest hangovers in the morning.³⁶⁸

High tax rates sometimes lead to smuggling, as potential criminals see the opportunity for profit if they can sell items subject to the excise tax for a high profit in the black market. The government of Canada was recently pressured into reducing the tax on a carton of cigarettes so that a carton could sell for

363. GUIDE FOR FOREIGN INVESTORS, *supra* note 286, at 40-41

364. *Id.*

365. *Id.*

366. *Id.*

367. Ostaskovs & Markēvics, *Latvia Enacts Changes to Profits Tax, VAT, and Excise Tax*, in TAX NOTES INT'L, *supra* note 307, at 491.

368. *Id.*

C\$23.³⁶⁹ Before the excise tax reduction, Canadian cigarettes were selling for C\$47 a carton, compared to about C\$20 to C\$22 for illegal cigarettes.³⁷⁰ An estimated 30% of all cigarettes smoked in Canada are smuggled; that percentage climbs to 65% in Quebec province.³⁷¹

Domestic producers of products subject to excise taxes could find it difficult to compete with foreign brands if the rate is too high. Russia recently had to reduce its excise tax on vodka for this very reason. Kristall, the manufacturer of Stolichnaya vodka, laid off workers and said that high taxes were driving it out of business.³⁷² As a result, the government reduced the excise tax to 80%, from the previous 90%.³⁷³ Whether this reduction will be sufficient to bring the vodka industry in Russia back to good health remains to be seen, but it should be pointed out that the excise tax in Latvia is much higher than the Russian tax, which makes Latvia less competitive. The Latvian excise tax should be reduced to competitive levels.

I. *The Social Tax*

Latvian employers pay a social tax of 37% of payroll.³⁷⁴ Legal persons that pay fees or royalties are also subject to this rate.³⁷⁵ Working invalids pay 8%.³⁷⁶ The rate for agricultural work and for processing one's own agricultural production is 18.5%.³⁷⁷ Individuals pay 1% of income.³⁷⁸ There are exemptions for:³⁷⁹

- pensions, material aid, other payments from the social insurance budget;
- compensatory payments, excluding compensation for unused annual leave in certain cases,
- compensation for damages for loss of capacity to work,
- allowances paid to students,
- material aid paid for natural calamities or for other extraordinary reasons,
- payments for giving blood and other donations,
- royalties paid to foreigners who do not live in Latvia, and
- wages of daytime students.

The social tax is not imposed on dividends, interest, royalties or pensions.³⁸⁰

Everything previously mentioned about the U.S. Social Security tax could also be said about the Latvian social tax. The tax is too high, it distorts the economy, misallocates resources, impedes capital formation and retards economic growth. Tax funds are not accumulated and cannot be passed to heirs at

369. Tamburri, *supra* note 223, at B12.

370. *Id.*

371. *Id.*

372. *Vodka Distiller Feels a Bite*, WALL ST. J., Feb. 9, 1994, at A10.

373. *Postscripts*, WALL ST. J., Feb. 10, 1994, at A15.

374. GUIDE FOR FOREIGN INVESTORS, *supra* note 285, at 41.

375. *Id.*

376. *Id.*

377. *Id.*

378. *Id.*

379. *Id.*

380. *Id.* at 42.

death. People are fooled into thinking they will have something at retirement, when in fact they may not. The pension system should be privatized as soon as possible. Compared to Latvia's tax rate, the U.S. tax rate is much lower,³⁸¹ but the tax rate in some other countries is much higher.³⁸² However, the point is not whether rates are relatively high or relatively low, but that there are rates at all. Many advantages are to be gained by privatizing the system.

VIII. RECOMMENDATIONS FOR LATVIA AND OTHER EMERGING ECONOMIES

Latvia and other emerging market economies should not adopt a tax system similar to that of the United States. The U.S. tax system has many problems, problems that could be avoided by a little advance planning. As noted above, the U.S. tax system is overly complex and costly to administer. It is vague in many places. Even tax practitioners who have many years of experience cannot compute the correct tax liability, as was shown in the studies noted above. The US system is not stable. Since the rules are determined from a number of sources—Congress, the Internal Revenue Service and three separate federal court systems—the rules change a little bit each day. Tax regulations are sometimes made retroactive, which is unfair and hinders tax planning.

The U.S. system is unfair in many ways. The ability-to-pay principle is the basis for some taxes, such as the graduated income tax and the estate tax, which reduces social harmony and is exploitative. The vast majority of taxes, especially at the federal level, are collected through coercion or the threat of coercion, which disparages property rights and reduces individual freedom.

Policymakers who want to establish a good system of public finance should base their decisions on the following principles:

- The system should be noncoercive and nonviolative of property rights to the extent possible. From this principle, it follows that revenue sources like lotteries and user fees should be used first, since these are the only noncoercive means of raising public funds. Coercive means should be resorted to only if the amount of funding needed to provide for the legitimate functions of government cannot be raised completely by noncoercive means.
- Public spending must be kept under control. The less public spending, the less need there will be for coercive taxation and the less drain there will be on the private sector, which is the source of economic growth. An effective means of minimizing public spending is by privatizing everything possible. Social security is one area that is ripe for privatization in almost every country in the world. Social security expenditures account for a large percentage of government spending in countries that have public social security systems.³⁸³ Most

381. WEST'S FEDERAL TAXATION: INDIVIDUAL INCOME TAXES, *supra* note 236, at 1-15.

382. Tanzi, *Tax Reform*, in THE ROLE OF TAX REFORM, *supra* note 140, at 19, 25.

383. For example, Social Security payments in the United States account for about 21% of federal government expenditures. That is higher than any other category of federal spending. The

other services that are currently provided by government can also be improved by privatization.

- Of the two competing philosophies of taxation, the cost-benefit view is morally and economically superior to the ability to pay philosophy. The ability to pay philosophy exploits the most productive members of society, exacerbates class conflict and dampens incentives to work and create wealth, which leads to reduced economic growth. The cost-benefit principle at least makes an attempt to match the benefits of government services with the cost of those services.

- Taxes should be visible, not hidden. Hiding the true cost of government from the people who must pay is dishonest and constitutes a breach of fiduciary duty³⁸⁴ by those government officials who make tax policy. It must be remembered that the government is the servant of the people, not the master. As the servant, it must not hide the cost of government from the people, who are the masters. Thus, a value added tax at the retail level is to be preferred to a value added tax at the manufacturer level, since manufacturers pass on this tax to the consumer by raising prices. To the extent that the tax cannot be passed on to consumers, the shareholders pay it in the form of a reduced return on investment. A retail VAT that charges separately for the tax is to be preferred to one that includes the tax in the price because charging separately makes the tax visible. If taxes are visible, it is more difficult to raise taxes. Furthermore, low tax rates are more conducive to economic growth than are high tax rates. Therefore, a visible tax system enhances economic growth (or does not retard it as much) more than a hidden tax system does because a visible tax system puts an extra brake on tax rates.

- The tax system should not be used to encourage or discourage certain activities. In a market economy, the price system sends signals to producers and investors about the most productive uses of resources. Granting lower tax rates or tax subsidies to certain industries that have political influence causes resources to shift away from what consumers want, thus causing resources to be allocated less efficiently than would be the case in a free market.

- Low tax rates are better than high tax rates. While this may seem obvious, many governments in the past have forgotten this very basic fact. The higher the tax rates are, the more resources that will be diverted away from the private sector. High tax rates also discourage production, which results in a reduced rate of economic growth. High rates also are more likely to violate property rights.

- Tax rates should be uniform, not discriminatory. Rates should not differ based on income level, marital status, activity engaged in, and so forth. Having

next highest category, national defense, is slightly over 19%. ROGER LeROY MILLER, *ECONOMICS TODAY: THE MICRO VIEW* 116 (8th ed. 1994).

384. Politicians and other policymakers owe a duty to their employer (the people) to act honestly and not to hide things from them. The employer (the people, in the case of government) has a right to know the full cost of the services its employees (politicians and bureaucrats) provide, and hiding this information from the employer constitutes a breach of fiduciary duty.

discriminatory rates opens the floodgates to every special interest under the sun. If there is more than a single rate, these special interests will petition the government for special tax treatment. All citizens should be treated alike in every respect. This means that if an income tax is part of the public finance system, it should not be graduated. Everyone should pay the same rate. If there is a value added tax or a transfer tax, the rate should be the same for every product or service being taxed. Equal treatment for everyone enhances social harmony, reduces exploitation and makes it possible to have a much simpler system than would be the case under a discriminatory system.

- A simple system is to be preferred to a complex system. Yet in practice, western economies have uniformly violated it. Western systems are far too complex, primarily because they are trying to do too much. Complexity increases as special interest groups are granted privileges and as certain other groups are penalized. This fine tuning³⁸⁵ increases complexity and should be avoided. Complexity can be an especially serious problem in an emerging economy since these economies have the least amount of resources to pay the administrative costs of such a system.

- A tax system that is easy to administer is to be preferred to one that is difficult. Most western democracies violate this basic principle. Thus, emerging economies must be extremely wary of adopting a western-style system, since these systems are expensive to administer.

- A system where collection is easy is to be preferred to a system where collection is difficult, all other things being equal. All other things are not equal. Collection may be enhanced by increasing the amount of coercion and human rights violations. But such a solution may be worse than the problem.

- Earmarking taxes for certain purposes has several advantages over a tax system that pours all revenue into a common fund. For one thing, taxes that are earmarked for a popular function will have more public support than a tax that is dumped into a common pool, which the public might perceive as being mostly wasted. Earmarking is also efficient from an economic standpoint. In the case of gasoline taxes, for example, these revenues are used for road building and maintenance. Gasoline taxes, which are basically user fees, follow the cost-benefit principle since the people who pay are the ones who benefit from the service.

- There is no such thing as a neutral tax. Any tax will cause resources to flow in directions that are different than would be the case in the absence of the tax. Distortionary effects should be minimized to the extent possible. One way to minimize distortion is to keep taxes as low as possible.

- Taxes have a dampening effect on competitiveness and economic growth. This dampening effect can be minimized by keeping tax rates low. If the tax

385. "Fine tuning" is a term Keynesian economists use when referring to the use of the tax system to engage in fiscal policy. Those who disagree with the Keynesian use of the tax system to foster fiscal policy goals would argue that the tax system should be used to collect the revenue necessary to pay for government services, not to engage in social engineering.

rates in Latvia are lower than those in other countries, Latvia may tend to experience more capital inflows and more rapid economic growth. Thus, the tax system can be used as a vehicle of economic growth. However, there is danger in using the tax system for something other than collecting revenue for government functions. If used as a tool of industrial policy, the tax system can be used to support specific industries at the expense of the general population. This temptation must be avoided.

- Clear rules are to be preferred over vague rules. Again, what is obvious is not being implemented in practice. While the U.S. example was used in this article to illustrate how vague tax rules can be, an examination of the tax systems of other developed countries would reveal the same situation. Tax rules in the United States are frequently much more vague and unclear than need be. This ambiguity results partly from the overcomplexity of the system and partly because of a lack of foresight on the part of tax planners.

- The tax system should have stable rules. A stable tax system should be preferred to a system where the rules change frequently. Frequent rule changes make it more difficult for businesses and individuals to plan, thus increasing uncertainty. Where there is uncertainty, investment, both foreign and domestic, is retarded. Thus, an unstable tax system can do an especially large amount of damage to an emerging economy that is trying to attract foreign capital and trying to keep domestic capital from fleeing the country. If the tax system is a good one, there is no need for frequent rule changes. Frequent rule changes tend to occur in countries that try to use their tax system to reward or punish certain groups or activities.

- The tax system should be as neutral as possible as far as behavior and incentives are concerned. The incentive to produce is dampened by having high graduated rates. The incentive to marry or remain single can be affected by having different tax rates for married and single individuals. The tax system should not be used for social engineering purposes. In a free country, individuals (the masters) should be free to live their lives as they wish without having their government (the servant) pressure them into certain preferred modes of behavior.

- The tax system should promote social harmony, or at least it should not exacerbate class conflict. Thus, tax rules that treat individuals or classes differently should not be a part of the system.

- The amount of tax collected should exceed the cost of collection. If it costs more to collect a tax than the amount of revenue raised by the tax, it does not make sense to keep such a tax on the books. The luxury tax that was enacted as part of the 1986 Tax Reform Act in the United States violates this principle. Emerging economies must avoid making similar mistakes.

Latvia's tax system is in its infancy, which is an advantage. A new system is easier to change than a system that has been in place for decades. Thus, Latvia can place itself at a competitive advantage over the more mature market economies that are burdened with complex systems of tax rules that evolved and

became entrenched over generations. By following the above rules, the Latvian tax system can be more efficient and attractive than anything presently existing in the West. Such a tax system can enhance rather than deter economic growth. Such a system can attract rather than repel foreign investment.

Latvia's present tax system contains some good features as well as some negative ones. Its tax system is not as broad-based as it could be. But this is not necessarily bad. The fact that it does not have an estate, gift or inheritance tax³⁸⁶ is a good thing. Adopting such taxes would retard economic growth and exacerbate class conflict, among other things. Another good point is that Latvia's present policy does not include inflating the currency to pay for government services.

Latvia's arsenal of tax tools includes a lottery, one of the few methods of raising revenue that does not violate property rights. Thus, a major suggestion is to expand the use of a lottery to the extent possible. Raising funds by means of a lottery reduces the need to raise funds by resorting to some form of coercive taxation.

The *Guide for Foreign Investors* did not list user fees as one of the taxes now in use in Latvia. Perhaps that is because user fees do not fall strictly within the definition of taxes since they are not coercive. But user fees are in use in Latvia. They are one of the preferred methods for raising money for governmental functions because they do not force everyone to pay for benefits that are only enjoyed by users. User fees are based on the cost-benefit principle rather than on the ability-to-pay principle and are thus a superior form of revenue raising from a philosophical and moral perspective.

User fees should be expanded to the extent possible. The major suggestion with regard to user fees is that they should be made to reflect the relevant costs. Otherwise, if fees are too low, the general populace will have to subsidize activities that are enjoyed only by some, which is both unfair to the general public and a misallocation of resources. On the other hand, if fees are too high, then users will be subsidizing some other government activity and use of the facility or service for which the user fee is charged will be discouraged.

One criticism of the Latvian tax system is that the system is not stable. The rules change too frequently. Latvia established its tax system in 1991 and made major changes to the system in 1992 and 1993. While it is understandable that a newly established system might require frequent changes in order to fine-tune, if frequent changes become entrenched in the system, as is the case in the United States, the resulting instability will add to the system's complexity, discourage investment, and increase the possibility of evasion.

The Latvian social security system should be privatized. Privatization would have several benefits. Citizens would no longer have to depend on the government in their old age. But more importantly, a vast amount of capital could be accumulated for investment, which would spur economic growth. If

386. Law on Resident Income Tax art. 9.7.

the funds now being collected to pay the social security benefits of those who are already retired could be channeled into private investments, Latvia could become heavily capitalized within a single generation. The pensions of those who are already retired could be funded by selling off state assets, which would solve the major problem of converting to a privatized system. Privatization has been suggested as a solution to the social security problem in many countries, and some countries have started to privatize their systems.³⁸⁷ There is no reason why Latvia cannot do so as well.³⁸⁸

Although Latvia does not tax individual capital gains, it does tax business capital gains as part of the profit tax.³⁸⁹ Many countries either do not tax capital gains or tax them at a very low rate.³⁹⁰ Thus, Latvia is at somewhat of a competitive disadvantage. If Latvia wants to continue taxing capital gains, at the very least, it should take inflation into account when determining the gain to be taxed. Much of the gain in a capital gain is inflationary gain. In the interest of fairness, this inflationary gain should be excluded when capital gains are taxed, if capital is to be taxed at all.

Latvia's profit tax is too high, at least in the upper ranges. If profits are to be taxed at all, they should all be taxed at the same low rate. A flat rate would be less unfair and would enable the tax system to be far simpler than could be the case where a multitude of rates exist.

The profit tax should not favor certain groups or punish other groups. The current rules punish banking, insurance, and trade activity, by charging these industries a higher rate of tax. The casino and private lottery industries are also penalized by higher rates. Those who engage in charitable giving, agriculture, or sports activities are given more favorable treatment than the general population. Granting special treatment to any group opens up the possibility of having other special interests place pressure on the legislature to grant special privileges or special treatment for them as well, which would cause distortion and cause the tax system to become more complex. Much of the complexity in the US tax system is the result of such special interest lobbying. The temptation to grant

387. For more on the privatization of social security, see Glenn Jenkins, *Privatization and Pension Reform in Transition Economies*, in PUBLIC FINANCE IN A WORLD OF TRANSITION 141-151 (Pierre Pestieau ed., Proceedings of the 47th Congress of the International Institute of Public Finance/Institut International de Finances Publiques, St. Petersburg, 1991), Supplement to 47 PUBLIC FINANCES/FINANCES PUBLIQUES (1992); Peter J. Ferrara, *The Privatization of Social Security in Chile*, 3 J. ECON. GROWTH 18-27 (1989); James M. Buchanan & Colin D. Campbell, *Voluntary Social Security*, WALL ST. J., Dec. 20, 1966, at 14; John C. Goodman, *Opting Out of Social Security: Why It Works in Other Countries*, in PRIVATIZATION, *supra* note 3, at 79-86; Peter J. Ferrara, *Social Security and Super IRAs: A Populist Proposal*, in PRIVATIZATION, *supra* note 3, at 87-97; FITZGERALD, *supra* note 3, at 205, 257-262; PIRIE, *supra* note 3, at 220-223, 289-90; John C. Goodman, *Privatizing Medicare*, in ENTREPRENEURSHIP AND THE PRIVATIZING OF GOVERNMENT 107-108 (Calvin A. Kent, ed. 1987); Goodman, *supra* note 239, at 103-15; E. VICTOR MORGAN, CHOICE IN PENSIONS (Institute of Econ. Affairs ed., 1984); HENRY J. AARON ET AL., CAN AMERICA AFFORD TO GROW OLD? PAYING FOR SOCIAL SECURITY 116-120 (1989); PETER J. FERRARA, SOCIAL SECURITY: THE INHERENT CONTRADICTION (1980).

388. *See id.*

389. Latvian Finance Ministry.

390. For details, see COOPERS & LYBRAND, *supra* note 142.

special treatment to any one group must be avoided at all cost lest the system evolve into something resembling that of the United States.

The Latvian personal income tax is based on the ability to pay principle, which is morally bankrupt. The present, graduated rate system should, at the very least, be replaced with a single-rate system. The rate chosen should be low enough so as not to dampen incentives. If spending is restrained and everything that can be privatized is privatized, it probably will be possible to eliminate the personal income tax altogether. The personal income tax is more invasive of personal rights and privacy than almost any other tax, and the potential for abuse continues to exist as long as the personal income tax is part of the tax system. If some form of coercive taxation is needed, a value added tax at the retail level is preferred to the personal income tax because it is less invasive to privacy and it will have less of a dampening effect on incentives. In other words, an income tax dampens incentive to work and invest; a value-added tax does not.

There is no need to have property and land taxes. A simple value added tax at the retail level would raise all the revenue that a property or land tax would raise without the complications and incursions on property rights that would be necessary with a property or land tax. Again, it may be possible to eliminate the need for a retail consumption tax if the extent of governmentally-provided services is significantly reduced. A retail consumption tax should be preferred to a land, property or income tax. However, such a tax may not be necessary, depending upon how far government services and expenditures can be cut. If a turnover tax is needed, there should be just one rate, and that rate should be low enough to be competitive with the rates in other countries. The recent increase in the turnover tax rate was a step in the wrong direction.

An excise tax may or may not be desirable depending on the facts and circumstances. If an excise tax is placed on gasoline with the proceeds earmarked for road maintenance and repair, the tax closely resembles a user fee, since only those who use roads will pay the tax. But if an excise tax is imposed on alcohol and tobacco products with the intent of discouraging consumption of these items, the excise tax is being used as a tool of social engineering, which is an illegitimate function of government.

In summary, there is room for hope with regard to the Latvian tax system. The system is young enough to be flexible. It is not entrenched to the extent present in western tax systems. But there have been some moves in the wrong direction, such as the adoption of an income tax with graduated rates and a transfer tax³⁹¹ with rates that are too high. However, these features of the present system can be changed as the economy is privatized and the need for government funding is reduced.

391. The Latvian transfer tax is like the U.S. sales tax.