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The Case for Abolishing Federal Taxation

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Abstract
Abolishing federal taxation would dramatically alter the incentives that increase spending and taxing. State taxation would: 1) discourage wasteful Keynesian policies aimed at fine-tuning the economy, 2) encourage federal authorities to spend tax money only on activities providing national benefits, 3) reduce incentives for the rent-seeking that leads to wasteful spending at all government levels, 4) convert each state's incentive to free ride off other states' tax payments into an incentive to replace wasteful outlays with productive spending, 5) intensify competition between states and minimize the dead-weight loss of taxation, and 6) reduce the social divisiveness of political plunder.

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I. Introduction

Over the past 100 years, the power to tax has been shifting in one direction—toward the federal government and away from state and local governments. Diminished freedom to control our lives has followed closely behind. We keep a smaller percentage of our earnings, we face greater government intrusions into decisions that used to be considered private, and we have become increasingly dependent on, and disappointed with, government at all levels. As government has assumed responsibility to solve more of our problems, federal and state authorities have promised so much and performed so poorly that few of their promises can be kept and few of their solutions have worked. Despite the disappointment, however, government expansion has created incentives that make it individually rational for people to continue demanding more government even though it is collectively destructive.

As the problems they caus have worsened, large and fiscally irresponsible governments have responded by becoming larger and more fiscally irresponsible. This cannot continue. The reality is that significant changes must be made, and painful adjustments are unavoidable. Postponing the short-term pain of serious reform while going through the pretense of making tough decisions will result in the far greater pain of adjusting to a long-term decline in our prosperity and liberties.

The only hope for restoring fiscal responsibility in government is to radically decentralize government's power to tax. Indeed, we shall make the case for abolishing federal taxation altogether. This is clearly a radical proposal, though not as radical as proposals by some who want to abolish all taxation. But we make our proposal not with the expectation that it will be adopted in its entirety, but with the objective of highlighting the perversity of existing political incentives and the need for bold political reform.

II. It's the Incentives, Stupid

The country's creeping centralization of political power shows up in the ratio of federal receipts to all government revenues, omitting federal transfers to state and local government to avoid double counting. From 1900 through the 1930s, the ratio stayed in the range of 30 percent to 36 percent, except during U.S. involvement in World War I. After spiking to a high of 84 percent during World War II, the ratio declined, but it never dropped back below 50 percent. After 1970, federal receipts leveled off at around two-thirds of all government revenue, but the ratio began to soar in late 2008 as Washington's spending significantly increased as a percentage of GDP.[1]

With most tax revenue being paid to, and allocated by, the federal government, interest groups have added incentive to organize for the

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[1] Receipts understate the fiscal power of the federal government relative to state and local governments, particularly in recent decades, because federal spending has, with minor exceptions, exceeded receipts since 1960, and spending not covered by current receipts leads to deferred taxes, often in the form of inflation. In addition, there are reasons for believing the federal government's increased power to tax has served to increase the taxing power of state and local governments as well. The ratios for 1900 to 1940 came from the Tax Foundation's calculation based on National Income and Product Account data. The later ratios came from Table B-82 on page 427 of the 2010 Economic Report of the President.

purpose of influencing federal fiscal decisions. Boosters will try to get more federal spending for their towns, cities, or congressional districts. Business lobbies will try to get federal subsidies or bailouts for their industries. Demographic groups will try to get more federal money for programs that serve their members' interests. All of these groups will lobby for tax breaks to reduce their share of the costs. The federal government's seemingly boundless ability to borrow makes all this even more enticing because the costs can be shifted to taxpayers too young to vote or to those yet unborn.

Of course, these efforts are costly, and after factoring in lobbying expenses and red tape, each group's net gain from federal benefits is far less than the cost to taxpayers (current and future). And as federal programs have proliferated, more recipients end up receiving less from their programs than what they are paying for everyone else's programs. It amounts to a negative-sum game in which almost everyone ends up worse off. Yet, there is no incentive to stop playing because each group realizes that acting responsibly by seeking less in federal benefits will not reduce its tax burden but simply divert federal government largess to other groups.

Full awareness of the negative-sum consequences of centralized taxation power will not reduce demand for government spending or increase support for fiscally responsible political representation. Quite the contrary. Being aware that tax centralization creates opportunities for some to receive benefits at the expense of others makes voters eager to elect representatives who promise to "bring home the bacon" in spite of the collective harm of doing so.

This explains why congressional incumbents are typically reelected although the Congress as a whole ranks only slightly ahead of swine flu in popularity. Each politician knows that constituents dislike government spending in general—but not as much as they like increased spending on programs they favor. Even if we only elected politicians who genuinely understood the benefits of reducing taxes and government spending, it would provide little restraint as long as most of our tax dollars go to Washington DC because the only way to get some of them back is to lobby for more federal spending.

The shift of political power from state and local authorities to the federal government has not come from a plot hatched by some conspiratorial cabal. Instead, it resulted from incremental responses motivated by diverse interests. Each group benefiting from government spending will generally see the advantage in having more spending financed by the federal government. Each added bit of centralization reduces political resistance to increased funding by spreading the costs over a larger population.

Of course, any particular interest group's influence with the federal government may diminish as more groups succeed in centralizing funding for programs they favor. But this only serves as a motive for getting federal funds sooner rather than later. And that's not the end of it. As more groups become dependent on an expanding central government, federal workers gain a greater incentive to maintain and expand those groups' demand for government largesse. Their jobs depend on it.

The beneficiaries of expanding state and local governments may also favor concentrating power at the national level. As the federal share of total taxes increases, competition for tax revenues diminishes between state and local governments because regional differences in total tax burdens become relatively smaller. Incentives to move from high-tax to low-tax states diminish.

In addition, Washington transfers some money to state governments through revenue sharing. These arrangements typically reward states for maintaining or increasing their own tax revenues rather than substituting federal transfers for state levies.[2] We might regard revenue sharing as a tax cartel of local, state, and federal governments that reduces the difficulty of squeezing more money out of taxpayers at all levels of government.

Fiscal centralization has occurred slowly over time, but incremental decentralization of taxing power is unlikely to succeed because it requires opposing entrenched interests one at a time. Building support for fiscal restraint would be difficult because any group that contributed to the reversal of the centralized fiscal power by accepting federal cuts in their programs would suffer large losses on the spending side and receive only miniscule gains on the taxing

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[2] In the United States, these transfers from the federal to the state governments have taken a variety of forms over the years. From 1972 to 1987, many of the transfers were formula driven and made through what was known as revenue-sharing programs. These transfers were largely replaced with block grants beginning in 1987, but incentives for state governments to maintain tax revenues remained. Transfers from the federal government to state and local governments have expanded in recent decades. They were 4.3 percent of federal receipts in 1960, 10.3 percent in 1990, and 14.2 percent in 2007. These data were derived from Table B-82 of the 2010 Economic Report of the President.

side. The best approach in a situation like this is not to fight the alligators one at a time, but to drain the swamp.

III. Restoring Fiscal Federalism[3]

Draining the political swamp won't be easy. A great number of interest groups have grown comfortable with current centralized political arrangements. However, this comfort rests on trends and outcomes from political centralization that are not sustainable—most glaringly, ballooning federal budget deficits, a deepening quagmire of national debt, and unfunded liabilities as far as the eye can see.

In the past few years, widespread recognition of these realities has fueled a growing frustration with the relentless expansion of federal spending and control. The absurdity of trying to prevent the social disruptions and economic waste of excessive government with more government is becoming painfully obvious. There will be resistance to political reform radical enough to impose real restraint on central government power, but the recognition is increasing that bold action will ultimately be less painful and more productive than futile attempts to tinker with the status quo.

It is with this in mind that we propose eliminating the federal government's power to tax. The idea rests on the precedent set by the Articles of Confederation, which served as the constitution of the 13 original states from 1781 to 1789. The long-standing complaint about the Articles was that the central government—the Congress of the Confederation—was chronically underfunded because it was dependent on the willingness of the states to provide revenue. It's worth noting, however, that this complaint may be overstated. Sobel (1999) makes a strong argument that the collection rate under the Article sof Confederation was as high or higher than it was under the subsequent U.S. Constitution of 1789.[4]

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[3] Federalism refers to an arrangement in which the primary locus of political power resides in the states, with the states deferring to the federal government only for the purpose of providing a limited number of services to the states that, though important to all states, no individual state would find it advantageous to provide on its own.

[4] Dougherty (2001) presents a detailed examination of the free-rider incentives that hampered the central government's ability to raise revenue under the Articles of Confederation. Although he argues that federal government was underfunded, he makes the case that revenue was greater than implied by the standard model of voluntary payments for collective (or public) goods.

Our proposal would require each state to transfer some specified percentage of the tax revenue it collected to the federal government—say 35 percent.[5] This figure isn't arbitrary. It is the high end of the range of the federal share of total government receipts for most of the first four decades of the 20th century—and for most of the 19th century as well. The percentage of transferred revenue would be the same for all states. This restriction eliminates the rent–seeking activities that would inevitably result from states wasting resources in a zero-sum game lobbying for differential advantages.

If adopted, this proposal would: 1) discourage wasteful Keynesian fiscal policy aimed at fine-tuning the economy, 2) encourage federal authorities to spend tax money only on activities that provide national benefits, 3) reduce incentives for the rent-seeking that leads to wasteful spending at all levels of government, 4) convert the incentive each state has to free ride off the tax payments of other states into an incentive to replace wasteful outlays with productive spending, 5) intensify competition between states and minimize the dead-weight loss of taxation, and 6) reduce the social divisiveness of political plunder. All told, restoring fiscal federalism would reduce the negative-sum consequences of taxation and government spending while increasing positive-sum possibilities.

IV. Substituting Efficiency for Waste

The most direct consequence of abolishing federal taxation is that the federal government would have less to spend. Just as important, shifting the taxing authority to the state level would create incentives for all levels of government to spend their revenues more efficiently.

Consider first the tremendous amount of wasteful federal spending justified as necessary to moderate macroeconomic fluctuations. Space doesn't allow a full-blown discussion of the effectiveness of Keynesian policy, but it is enough to note that the evidence in support of government spending to take the edge off the business cycle is highly controversial. Keynesian policy has more to do with winning political support from voting blocs than with economic stabilization. Keynes is trotted out as an excuse to spend

[5] Local governments could have the same fiscal relationship with the states that the states have with the federal government, but it would be reasonable to let state and local governments work out their own arrangements because of the discipline from the additional fiscal competition between the states that our proposal would impose.

more when unemployment is increasing, but he's ignored during economic booms, when Keynes called for political unpopular reductions in spending (Buchanan and Wagner, 2000).

Even if politicians were serious about spending to smooth out economic fluctuations, the inability to forecast accurately would result in misguided efforts that destabilize the economy at least as often they stabilize it. Much of this spending actually slows up economic recovery by sheltering people against the need to make the market adjustments needed for recovery. By contrast, abolishing federal taxation would reduce the money available to create moral hazards by protecting people against the consequences of bad decisions that lead to more frequent and severe economic downturns.

In addition to eroding the Keynesian pretense for federal spending, our proposal would weaken the incentive for wasteful pork-barrel projects, regardless of their justification. Currently waste trumps efficiency in government spending because of the political influence of special-interest rent seekers, who have little concern with the social cost of their special interest demands. Consider federal spending on purely local services. Bike paths, community swimming pools, tennis courts, softball fields, street repair, police services, medical facilities, and local performances of Cirque du Soleil are just some of the local services that are routinely paid for, in whole or in part, by the federal government. Few of these services are worth as much as they cost even in total, not to mention at the margin, and those that make economic sense would be worth paying for with state and local taxes—without federal assistance. Of course, local groups are enthusiastic about federal funding of these local services because others are paying most of the cost.

If the federal government were dependent on the states for its revenue, wasteful federal spending on state and local services would decline quickly. Federal authorities would have little incentive to respond to demands for such spending. Instead of realizing political advantages from responding favorably to lobbying by state and local governments, the opposite would be true. Those state and local services worth more than they cost would be funded with state and local taxes without central government assistance. By paying for these purely local services, the federal government would reduce the need for state governments to raise tax revenue, which would cut into its only source of revenue.

The incentive for the federal government to reduce wasteful spending extends beyond funding projects for state and local governments. The federal government is able to raise revenues only through increasing state revenues, and the best way to do that is through expenditures that promote economic growth over all states but that no individual state would benefit from making unilaterally. It would be very costly for federal authorities to fund wasteful spending, which would reduce the payoff to lobbying by all special-interest groups.

Incentives for state and local governments to fund services worth less than they cost would be weaker without the federal Treasury footing part of the cost. In addition, the federal "tax" on state tax revenues would help counter the influence of organized interest groups that, finding little rent-seeking success at the federal level, would otherwise focus at the state level in their hope for benefiting at public expense. The influence of organized interest groups within the states would also be moderated under decentralized taxation by more intense competition between states, which is greatly attenuated when the power to tax is centralized. With all taxation taking place at the state and local levels, wasteful spending in response to special-interest influence in one state would put it at a larger competitive disadvantage relative to other states than is currently the case. The motivation for individuals and firms to relocate from one state to another in response to differences in the type, quality, and cost of state and local services, known as the Tiebout (1956) effect, would be much greater when state and local taxes represent 100 percent of the total tax burden than when they represent approximately 35 percent of that burden, as is currently the case in the United States.

Under the current centralized tax structure, the competition that does exist between states does more to reduce efficiency than increase it. Currently states compete with attempts to free ride off each other by acquiring more of the money that is being sent to the federal government from all states. This is a negative-sum competition harming all states, but it would harm a state even more if it dropped out of the competition. Without federal taxation, state and local governments would still compete, but it would be positive-sum competition. With the federal government providing services that primarily benefited all states, each state would have an incentive to reduce its contribution for those services. The only way to do this is by eliminating expenditures on wasteful service and providing those services that are worth providing as efficiently as possible, thus allowing the state to raise less tax revenue and therefore pay less to the federal government.

The intensified competition between states would also result in less wasteful ways of raising tax revenues. The current federal tax structure, with its thousands of pages of complex instructions, regulations, rulings, and loopholes, is a disgraceful testimony to Congress' willingness to sacrifice the public interest by pandering to interest-group desires for special privileges.[6] Abolishing this monstrosity would eliminate the waste of federal taxation and improve the efficiency of most state taxation. Improving taxation is not difficult—in concept. Any moderately intelligent fifth grader could come up with a better tax system than the one currently imposed on taxpayers. The problem has always been the lack of political incentives, and abolishing federal taxation would create strong incentives for states to enact sensible tax systems. In the absence of federal taxation, any state that clung to a tax system riddled with complexity, unfairness, and wasteful distortions would experience a rapid exodus of its tax base. Politicians in all fifty states would quickly start enacting serious tax reform rather than just giving lip service to doing so.

V. Moderating Malice in Plunderland

The negative-sum fiscal competition of centralized taxing power creates social conflict by pitting state against state and interest group against interest group. This threat to social harmony is easy to overlook in its early stages. People typically concentrate on the benefits they realize from a competition that imposes costs on others. They ignore the costs others are imposing on them because the burdens begin quite small and are easily overlooked. Eventually, however, the focus starts to shift as everyone attempts to live at the expense of everyone else, eroding the benefits and escalating the costs. Resentments begin to build as people become increasingly aware that others are benefiting at their expense. As these grudges begin to smolder, politicians often find that fanning the embers into

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[6] A measure of the waste of federal taxation is the social cost it imposes in terms of inefficiency over and above the tax revenue it raises, or its excess burden. Browning (2008, p. 156) cites a study that estimates the marginal excess burden of the federal income tax is in the range of \$.30 to \$.50 per dollar raised.

open hostilities is the most effective way to mobilize support for them and for more transfer policies they claim will help the victims of existing transfer policies.

This no doubt is happening in America today. People get upset when their money is taxed away to bail out failing car companies, unionized autoworkers, and banks proclaimed to be too big to fail. Homeowners who bought properties they could afford and continue to pay their mortgages even on houses with declining value resent it when their tax dollars go to help those who default on houses they couldn't afford or simply find it convenient to shift investment losses to the public. Workers react angrily at the prospect of paying higher federal income taxes because they were outvoted by the increasing numbers who do not pay those taxes. Even the U.S. Census has become a source of conflict—not surprising, really, given the amount of federal money that shifts among political jurisdictions in response to the latest population counts (Walashek and Swanson, 2006). Nationwide, each person translates into $1,000 to $1,200 in federal funding to municipal governments (Kellog, 2010).

Abolishing federal taxation would not eliminate all conflicts between citizens of different states and members of disparate interest groups. But it would certainly reduce the hostility and divisiveness that results from the negative-sum struggle between jurisdictions and interest groups to recapture tax revenues the federal government took from them in the first place. Far less tax revenue would go to the central government, a far higher percentage of what did would be used productively to provide general benefits, and far more economic decisions would be made in response to opportunities for mutually beneficial cooperation through market exchange.

VI. Threats to Fiscal Reform

Real fiscal federalism would significantly alter the perverse incentives that have led to irresponsible and destructive taxing and spending decisions by politicians. Unfortunately, those perverse incentives have also motivated large numbers to develop occupational skills, make other investments, and fall into dependencies that make no sense when people are rewarded by increasing wealth instead of grabbing existing wealth others have created. These decisions were made on the basis of expectations and political promises that were never realistic, and painful losses and adjustments are looming as it becomes more difficult for politicians to continue using the tactics of denial and delay to evade the costly consequences of their fiscal malfeasance. But the sooner radical proposals such as abolishing federal taxation are considered seriously, the more likely it is that we will see reforms that restore fiscal responsibility and allow for more gradual and less painful adjustments.

Any major reform, however, raises questions about its effectiveness and durability. From the moment federal taxation is abolished, politicians and interest groups will attempt to evade and even reverse the fiscal decentralization—for the same reasons that taxing power became concentrated in the first place. Stepping back from centralized power does not in any way mute the incentive for special interests to receive government-funded goods and services that are being paid for by the public at large.

For example, federal lawmakers may try to undermine fiscal reform and increase their fiscal breathing space by imposing spending mandates on states. These directives are a staple of our current political arrangements. With decentralized taxing power in place, however, such mandates would meet with greater resistance from empowered state capitals. Any mandate would cost the states more than it does now because of the significant percentage of tax revenue that has to be transferred to the federal government. Furthermore, the federal government commonly encourages states to accept mandates by offering to increase federal funding or threatening to reduce it. If the states hold the power of the purse, neither the offer nor the threat would be as credible as it is today.

A tax-starved central government could resort to loose monetary policy or simply spend without taxing. To compensate for its inability to raise revenues directly, the federal government would have more incentive than it does now to pressure the Federal Reserve into financing deficit spending through money creation. Guarding against this subterfuge would require restrictions on money creation less radical than abolishing federal taxation—so if the latter were possible, surely the former would not present an insurmountable barrier. As a nice by-product, effective restrictions on monetary creation would complement reductions in discretionary "stabilization" fiscal policy, further unleashing self-correcting market responses during economic downturns.

Of course, the federal government could engage in deficit spending by borrowing from lenders other than the Fed. Such borrowing, however, would be subject to greater discipline because of the federal government's limited ability to raise the tax revenues to service and repay the debt. In other words, financial markets would exert more control than they do now over irresponsible government spending. Furthermore, moral hazard problems in financial markets would be reduced because politicians would have less ability to shift the losses of commercial and investment banks to the taxpayers with too-big-to-fail bailouts.

Politicians may resort to scare tactics to increase central government spending. There might indeed be a reasonable case made for allowing for some exceptions to the ban on federal taxation during real emergencies, such as war. The bar should be set high, though. It should take more than a president's signature on a declaration. Perhaps it should require significant supermajorities in both houses of Congress before presidential approval would put it into effect. This would restore the constitutional provision that declarations of war require an act of Congress and impose more restraint on presidential military adventurism.

Could fiscal decentralization endure these threats? The strong ideological movement necessary to eliminate federal taxation would probably prevent backsliding for a time—but not forever. Opposition to government expansion is subject to erosion. This reality does not mitigate the argument for fiscal decentralization; permanence is far too strict a standard for judging the desirability of any reform.

VII. The Need for Reform

The proposal presented here is radical, and also serious. Not serious in the sense that we expect it to be realized in the near future, but serious in the sense that it clarifies the root causes of our fiscal predicament. To confront the short-sighted fiscal irresponsibility that characterizes the federal government, we have to first understand that the mess we are in is the inevitable consequence of the centralization of political power, beginning with the power to tax, that has evolved over the last century.

Our attempt to promote this understanding has taken the form of a proposal to restore fiscal responsibility with an admittedly extreme scheme for decentralizing the power to tax. If we arrive at a proper understanding of the consequences of centralization, other proposals for fiscal federalism may trump ours in terms of both acceptability and performance. Of course, no proposal for decentralizing the power of government is a panacea. But how good does it have to be to be far better than what we have now?

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