

Do Complex Tax Structures Imply Poorly Crafted Policies?

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Abstract

The present paper argues that complex tax structure is an inevitable consequence of public decision making that is shaped by competition of political parties for office. Complexity as such is not a sensible characteristic to evaluate the quality or even the efficiency of tax policy. Rather, the degree of competition inherent in the political process that gives rise to the tax particulars is the key criterion in order to separate efficient tax policies from inefficient ones.

Kommunikation

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1 Introduction

In virtually all modern democracies tax systems tend to be extremely complex. This is so despite the fact that nearly every tax reform proposal discussed in the public aims at drastically simplifying tax structures. In Germany, for instance, simpler tax rules have been on the political agenda since more than fifty years. From time to time, efforts have been made to substantially disentangle at least particulars of the tax system. However, subsequent amendments always introduced new sorts of special incidences and allowances and, thus, led back to tax structures as complex and incomprehensible as before. It seems that the political process in itself has the strict tendency to produce complex, intransparent und unwieldy tax structures rather than simple, lucent and manageable ones. But why is it like this? What are the driving forces behind complex tax systems? Do they simply reflect corrupted politics and bad public management as conventional wisdom seems to tell us or are there more systematic mechanisms at work?

The present paper argues that complex tax structure is an inevitable consequence of public decision making that is mainly shaped by competition of political parties for office. Therefore, complexity as such is not a sensible characteristic to evaluate the quality or even the efficiency of tax policy. Rather, the degree of competition inherent in the political process that gives rise to the tax particulars is the key criterion in order to separate efficient tax policies from inefficient ones.

The following eight sections establish this argument. The next section characterizes an optimal tax system from a pure economic point of view. The third section introduces the policy perspective. The fourth section contrasts such an economically optimal tax system with a tax system that is optimal in a politician's perspective who seeks for office. Such a system has to take into account that it earns sufficient political support from the constituency. The fifth section points to some neglected issues when it comes to evaluate current tax reform proposals by taking into account appropriate political constraints. The sixth section addresses the question of whether tax systems which are merely designed in order to get political support (rather than being oriented at economic rationales) still satisfy properly defined efficiency criteria. The seventh section discusses the role of the functioning of democratic competition by considering some specific incentive structures of politicians and voters. The eighth section briefly addresses the problem of regulating democratic competition. Finally, the ninth section concludes.

2 An Ideal Tax System

In order to set the stage for an analysis of the efficiency characteristics of a tax system which results from a democratic decision process, consider a tax system that is oriented only at economic criteria. So, how should an economically optimal tax system be designed? Besides the obvious fiscal condition that it gives rise to enough revenue for public financing, it should pursue three objects: it should be perceived as fair, it should consist of simple and transparent rules, and it should be efficient in the sense that it avoids what economists call excess burden or dead weight losses of taxation.²

A fair tax system calculates individual tax burden according to individual economic ability such that people with identical economic ability face equal tax burden and people with higher economic ability face higher tax burden. A simple tax system leads to low compliance costs and administrative costs, i.e. it limits the costs that individuals and tax authorities incur in the process of taxation. Finally, an efficient tax system only leads to minor distortions of private decisions about how to use scarce resources. In this way, the tax system limits the excess burden of taxation. Excess burden arise when taxes induce people not do what they would do if they could base their decisions only on scarcity conditions as prevailing in private markets. Excess burden constitute a pure efficiency loss of taxation as they burden taxpayers without leading to government revenue. As an example consider excess burden associated with the so called window tax which was levied in the past in some European countries. The window tax conditioned tax burden on the number and size of the windows of the taxpayers' houses. Taxpayers could avoid the burden of the window tax by walling up their windows. However, that did not mean that they were not burdened by the window tax because avoiding the burden of the window tax typically meant sitting in the dark.³

Generally, if a tax designer tries to meet the conditions fairness, simplicity, and efficiency simultaneously, she will be confronted with various tradeoffs between these purposes. For instance, pursuing more fairness typically implies sacrificing efficiency. However, something like a golden mean does exist. Tax systems with low tax rates applied to broadly defined tax bases - this is the common view of most tax experts - optimally deal with the objectives simplicity, fairness, and efficiency.

² See, e.g., ALM (1996) for a more detailed description of an ideal tax system.

³ Tax avoidance may also mean moving to the shadow economy; see, e.g., WIGGER (2001).

3 The Policy Perspective

Tax systems which result from democratic decision making typically imply the opposite. They apply high tax rates to tax bases which are systematically narrowed by exemptions, allowances, provisions, and other special elements. Why, however, is there such a big difference between tax systems as a product of public choice and tax systems based on economic rationales? Is it that real tax rules are initially motivated by reasonable economic concerns which are then crushed in the process of democratic decision making? Thus, is the real tax system something like a bad result of initially good intentions?

Before evaluating tax policy from such a point of view, it should first be asked, why politicians should be guided by concerns like simplicity, fairness or efficiency at all. In a competitive democratic system politicians who seek for office have to employ those measures that guarantee a maximum of support by voters. Therefore, incumbents will prefer those tax policies which can be expected to maximize the number of votes, whether the policies are compatible with economic advice or not. A tax system with low tax rates applied to broadly defined tax bases is attractive from a political point of view, if and only if it is best in preserving power. However, if it turns out that complex tax systems have better prospects to succeed in democratic competition, the issue of simplifying tax rules becomes obsolete from a political point of view.⁴

4 Politically Rational Tax Systems

How will a politically rational tax system, i.e. a tax system which is successful in democratic competition, be shaped? Such a tax system will be characterized by two specific marginal conditions. The first condition implies that tax rates among voters will be adjusted until the reduction in expected votes, i.e. the marginal political cost of taxation, for raising additional tax revenue is equalized across all taxpayers. The second condition implies that the increase in expected votes by additional public spending, i.e. the marginal political benefit, equals the marginal political cost. Thus, the tax system is optimally balanced in a political sense, if no additional political support can be obtained by any change in tax rates. Therein, political support of the single voter depends on the burden he has to bear because of taxation. The burden includes direct tax levy as well as excess burden in the sense explained above. Both direct tax levy and excess burden depend on individual specifics and may vary substantially across

⁴ There now exists a variety of different politico-economic approaches to taxation. For a survey see HETTICH and WINER (1997).

taxpayers. Therefore, a politically rational tax system shall not consist of simple rules. In contrast, it will display individually tailor-made structures.

However, even the most complex real world tax systems do not contain completely individualized structures. In fact, the administrative costs of a completely individualized tax system would be extraordinary high. In order to limit administrative costs, real world tax systems do not treat every economic activity as a singular incident. Rather, different activities are sorted into particular tax brackets. As such, grouping activities will lead to a loss of political support. However, since grouping reduces administrative costs, it opens up opportunities either to lower the tax levy or to spend more on public goods which, in turn, leads to additional political support. Thus, sorting different activities into tax brackets implies a balance between a loss in political support because of grouping rather than individualization and a gain in political support because of lower administrative costs.

This line of argument also explains the various exception rules inherent in real world tax systems. Rather than defining for each activity a single tax base it may be more efficient in terms of administrative costs to offer some groups of people special tax privileges in order to preserve the political support of these groups. Often, such privileges seem to be arbitrary and inequitable. However, taking into account that privileges are not defined in order to pursue equity objectives but to achieve political support, they turn out to be systematic instruments of achieving and maintaining power.

From the policy perspective, the large number of elements in tax systems which result from democratic decision making can be seen as a rational strategy of politicians who compete for office. Such tax systems take full account of the behavioral responses of taxpayers. Moreover, they economize on administrative costs. They are not deviations from some ideal tax rules oriented at pure economic concerns. In contrast, they consist of rationally balanced structures. In the same vein, permanent amendments of existing tax law does not necessarily mean political piecemeal. Rather, such amendments are rational adjustments of the tax system to changes in the political and social environment. The issue of simplifying the tax code, on the other hand, can hardly be motivated within the political sphere: complex tax structures are politically rational.⁵

⁵ See HETTICH and WINER (1988), HETTICH and WINER (1998a) and HETTICH and WINER (1998b) for a formal derivation of complex tax structure as a politically rational strategy.

5 Tax Reform and Political Repercussion

When the current tax system represents an optimal strategy that balances the various interests of voters and economizes on administrative costs, then tax reform proposals solely derived from some abstract normative criteria lose practical relevance. This is because if the current tax system is the equilibrium outcome of political competition, then discretionary changes in the tax code can be expected to stimulate endogenous repercussions in other parts of the public redistribution mechanism. Consider, as an example, a switch from the current income tax to a consumption tax as proposed by some economists. Such a switch can be expected to eliminate negative incentive effects which are associated especially with capital income taxation and, thus, will promote private savings which may result in increased aggregate capital accumulation and growth.⁶ However, a consumption tax generally has a different incidence than an income tax. A consumption tax raises the tax burden of those groups who do not yet or who do not anymore belong to the labor force. In particular, a consumption tax can be expected to raise the tax burden on those later in life.⁷ The elderly, however, are a politically powerful group. In order not to lose political support of the elderly, government has to offer some compensation to the elderly for the higher tax burden caused by a switch from an income to a consumption tax. A possible compensation may be higher pension benefits. This, however, would necessitate higher contribution rates to the public pension program which, in turn, may trigger negative effects on employment and savings. Such negative effects may even dominate the positive effects associated with a consumption tax. This example demonstrates that a realistic discussion of alternatives to the current tax policy should take into account the likely or at least possible repercussions of changes in the tax code. Only if the repercussions are considered appropriately, the social virtues of tax reform can be realistically evaluated.⁸

6 Are Politically Rational Tax Systems Efficient?

The analysis so far has demonstrated that complex tax structures may be part of a rational political balance to maximize political support in a competitive democratic system. However, can a tax system which is merely oriented at political necessities be regarded as efficient? If the tax system is the equilibrium outcome of competition for office, in which political opposition is associated not only with direct tax burden but

⁶ See, e.g., SUMMERS (1981) for an analysis of the aggregate effects of a switch from an income tax to a consumption tax.

⁷ See, e.g., WIGGER (2004a) for an analysis of the intergenerational incidence of a consumption tax.

⁸ See also POTERBA (1998) for a discussion of this line of argument.

also with efficiency losses of taxation, then there will be no alternative tax system which gets as much political support as the equilibrium tax system and implies lower efficiency losses. This means that in a competitive democratic system those tax rules will prevail which imply the lowest efficiency losses for a given level of political support. In this sense the tax system is efficient. This argument does not exclude that other institutions may result in a more efficient tax policy. However, also a discussion of alternative political institutions has to take into account the competitive nature of democratic decision making. In the face of this argument, proposals to restrict the realm of democratic decision making by imposing, for instance, binding rules on the political process, appear in a rather problematic light.⁹ Although it may be possible to keep parts of tax policy free of strategic influences, one should expect that democratic competition will find new arenas. If, however, democratic competition has already resulted in a tax policy which is efficient in the sense defined above, then moving it to a new arena can be expected to lead to higher efficiency losses.

7 The Role of Democratic Competition

Whether democratic decision making leads to an efficient tax policy essentially hinges on the functioning of democratic competition. Only complete democratic competition can be expected to result in an efficient tax policy. In contrast, if democratic competition is incomplete, bad tax policies will not necessarily be superseded by better ones. In a next step, thus, it has to be analyzed whether real democratic competition in fact satisfies those conditions that guarantee efficient policy outcomes. The problem of completeness of democratic competition displays various parallels to the problem of the completeness of market competition, which is well-analyzed in traditional welfare economics. Both, in the policy and in the market context, decisions can be expected to lead to inefficient outcomes, if the agents involved do not have proper incentives to take the full benefits and costs of their actions into account. Thus, the specific incentive structures faced by the relevant agents have to be analyzed.¹⁰

Two central groups of relevant agents of democratic competition are politicians and voters. For the incentives of politicians it is essential how competencies to legislate tax rules are allocated. In countries with a federal organization like Germany both the central government and the states have legislative competencies. Often, as is the case in

⁹ See HOLCOMBE (1998) for a discussion of such proposals.

¹⁰ See also WIGGER (2004b) on this point.

Germany, the central government and the states share legislative competencies and tax revenue. Such sharing, however, in a sense weakens political responsibilities for tax policy as the central government and the states haggle over shares of common tax revenues whereby no government unit takes full account of the negative effects of taxation. The weakening of political responsibilities associated with such a form of federalism fosters inefficient tax policies.

There is also an incentive problem on the voters' side. For the single voter tax policy certainly has a pivotal influence on her voting decision. However, detailed information on the social consequences of different tax policies are not only hard to acquire for the single voter, such information also is of questionable value. This is because a single vote only has a negligible impact on election outcomes regardless of whether the respective voter is well-informed or not. Therefore, voters do not have particular incentives to incur costs in order to acquire information on the virtues and vices of different tax policies. Even if the single voter is convinced that voting decisions based on comprehensive information will lead to a more efficient use of public resources, it is also clear that her own voting decision is only of very little importance. Thus, if information is costly and only leads to low returns, it does not pay to acquire information. Instead, it is rational to stay ignorant.

Rational ignorance of the single voter is accompanied by an asymmetric distribution of information across voters about the social consequences of different tax policies. Information is less difficult to acquire and of larger value, where the interests of small groups of people or firms are concerned. In fact, the distribution of information on the social consequences of public policy is typically characterized by a low mean and a high variance.¹¹ Most voters only have little information. Some of them, in contrast, are very well informed. Such asymmetry of information involves the problem of adverse selection in politics. If voters cannot distinguish between good and bad policies on the basis of reliable information, it is not guaranteed that only good policies will succeed in democratic competition.

If democratic competition does not reveal, which policy alternative is the superior one, it becomes possible for small and well-informed groups to convince politicians to put their particular interests on the political agenda, even if this implies high social costs. Under such circumstances politicians can win elections with bad ideas and inefficient

¹¹ See FERREJOHN (1990).

policy measures. Informational deficits on the voters' side open up opportunities to pursue policies which benefit small groups of individuals at high social costs.

8 Regulating Democratic Competition?

Rational ignorance of most voters and the concomitant asymmetric distribution of information about the social consequences of tax policy bear the risk that inefficient policy measures may prevail in democratic competition. Similar to private markets, where an inefficient use of resources may obtain if the conditions of perfect competition are not met, democratic competition may fail. In the market context market failure usually serves as an argument for regulating competition. However, regulation of private markets often serves the purpose to hinder unwanted competitors rather than contributing to more efficiency. A similar problem may obtain in the policy context. Proposals to regulate democratic competition like restricting the regularities of policy party financing or limiting the opportunities for second jobs of members of parliament may be misused by incumbents to hinder political competition for office. It should also be considered that democratic competition itself may produce mechanisms to overcome the problem of adverse selection in politics. In private markets it pays for producers to establish a reputation of providing high quality when consumers cannot observe quality before purchasing the product. Similarly, in political markets it may pay for politicians to establish a reputation of honesty and welfare orientation if this increases the probability to win elections.

9 Conclusion

Complex tax structures do not necessarily imply poorly crafted policies. In contrast, they can be understood as an integral part of a rational strategy in order to acquire or to preserve political power. Especially, complex tax structures can be efficient in the sense that there is no other tax system which receives as much political support at lower efficiency costs. Whether a tax system that comes out of a democratic process is efficient or not essentially hinges on the competitiveness of the political process. In that context it is most important how clear-cut and transparent responsibilities of politicians and how lucent the redistributive consequences for voters are. The former can be improved by definition of more exclusive legislative competencies. The latter can be improved by providing better, i.e. less costly, information for voters.

Tax reform proposals which are designed on the basis of pure economic criteria play a role especially in connection with the latter point. They will not serve as blueprints for future tax reform. Rather, they provide information about policy alternatives. Such alternatives will then be put on the political agenda if politicians expect that they will lead to additional political support.

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