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COMMENT

REFORMING THE TAX CODE: A TALE OF TWO PURPOSES AND PARALYSIS

Gene Magidenko*

Though the presidential election of 2012 is still some time away, national politics have been in the thick of one for several months now. One of the top issues being debated is the tax code.[1] Most agree that the tax code should be simplified, but to say that the proposals to do this are various is an understatement. This perennial question of reform has been a fixture of the national debate for a long time, so little of what can be said about it is particularly novel. All the same, a brief overview of the purposes behind our system of taxation and how they inform the present debate about tax reform is useful. The ultimate conclusion, unsatisfying as it may be, is that there are serious systemic obstacles to any substantive changes to the tax code.

A HISTORICAL PERSPECTIVE

Until the early twentieth century, states were responsible for imposing most of the tax burden on Americans. The federal government primarily relied on tariffs and excise taxes and resorted only temporarily to income taxation during the Civil War.[2] During the Progressive Era in the early twentieth century, federal taxation achieved a new prominence that soon eclipsed that of the states. Following the passage of the Sixteenth Amendment in 1913, income taxation expanded prodigiously. Presently, the federal government imposes most of the burden on

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1. *See, e.g.*, Nina Easton, *It's Time for an Honest Tax Debate*, TERM SHEET (Jan. 25, 2012, 12:25 PM), http://finance.fortune.cnn.com/2012/01/25/obama-tax-debate/.

2. Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L. REV. 1793, 1803-04 (2005).

taxpayers—and specifically on their incomes.[3]

The history of federal income taxation suggests that two primary and occasionally conflicting schools of thought prompted the imposition of income tax. The first was born of a desire to raise revenue for the essential functions of government.[4] The government by its very nature must have some expenditures (the extent and allocation of expenditures, of course, is a constant source of contention) to fulfill its core constitutional functions of providing for the national defense, regulating commerce, coining money, maintaining a postal system, maintaining federal courts, controlling federal lands, etc.[5] There are a variety of ways in which the federal government could theoretically raise the funds to accomplish these functions. Among the various potential mechanisms are tariffs, excise taxes, consumption/sales taxes (e.g., a value-added tax), wealth taxes, property taxes, and income taxes. The choice of imposing income taxation may seem odd at first glance, because it is more difficult to collect and enforce at the national level than other taxes. But there are two reasons why income taxation is particularly attractive to a federal government that is constantly growing in size and scope (and the goal of which—frequently at odds with that of taxpayers—becomes to maximize tax revenues), notwithstanding administrative difficulties. First, such a tax creates a large tax base: a lot of people earn a lot of money. And second, an income tax allows the government to tax a single stream of wealth multiple times as it circulates through the economy. For example, a worker receives a sum of money, on which he is taxed, and which he spends in a store on various goods. The shopkeeper then spends the money (on which he in turn is taxed) on books. The bookstore owner too is taxed on that income, which he uses to buy a car. And so on.

The second and more recent school of thought behind a

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3. *Compare* Tax Foundation, *Selected Federal Rates*, 2012, TAX DATA (Feb. 16, 2012), http://www.taxfoundation.org/research/show/28015.html, *with* Tax Foundation, *State Individual Income Tax Rates*, 2000–2012, TAX DATA (Feb. 16, 2012), http://www.TaxFoundation.org/ taxdata/show/228.html. *See also* Kail M. Padgitt, *Tax Freedom Day Arrives on April 12*, TAX FOUNDATION SPECIAL REPORT, Mar. 2011, at 6 (Figure 2), *available at* http://www.TaxFoundation.org/files/sr190.pdf.

4. *See* Richard M. Bird & Eric M. Zolt, *Redistribution Via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, 52 UCLA L. REV. 1627, 1630 (2005) ("Taxes are used to raise revenue to fund government services . . . .").

5. *See* U.S. CONST. ART. I § 8.

graduated income tax is wealth redistribution.[6] The conscious allocation of wealth is a means by which the government can fund programs that disproportionately benefit only certain constituencies, an inevitable result in a pluralistic representative democracy. This is the primary factor differentiating the "wealth redistribution" purpose from the essential revenue-raising function of government noted in the previous paragraph. The latter, as originally envisioned, exists to fund the quintessential public goods—those from which all in society benefit relatively equally—and relies only on raising sufficient funds to cover those core functions. Wealth redistribution funds group-specific programs from which only some in society benefit.[7] The unlimited demand of various constituencies invariably means that the government seeks expansion of the supply of government services, whether core or otherwise. Additionally, the Progressive Era variant of this idea suggests that large accumulations of wealth in the hands of any given individual are undesirable.[8] There is a persistent preoccupation with wealth disparities. In an economy that is not planned top-down, the way to level incomes is to more-than-proportionally reduce the earnings of the more affluent by taxing their income directly. Whether this raises more revenue is not necessarily considered a relevant question.[9]

THE MODERN DEBATE

Viewing the modern debate over tax reform through the lens of these two competing ideas is particularly informative. It is

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6. *See* Bird & Zolt, *supra* note 4, at 1630, 1670 ("Countries also use taxes (and expenditures) to change the distribution of income or wealth.").

7. Some may counter that a redistribution program, like a safety net for example, disincentivizes over-saving and frees up assets to go to productive use. However, it is debatable whether disincentivizing over-saving is a public good. Indeed, higher savings rates can actually lead to greater and cheaper loan availability (assuming people save money in banks). This allows entrepreneurs to start more businesses and create additional wealth.

8. The idea is that there is supposedly greater social stability that comes with greater wealth redistribution. This is almost certainly not a public good. The putative recipients of redistributed wealth are either no worse off than they were before (if they get nothing) or are better off (if they receive money or benefits). On the other hand, those from whom money is taken for distribution are worse off in both scenarios (they either have to pay or face riots). In that sense, the argument for wealth redistribution as a means of alleviating social tensions is essentially extortive.

9. *See, e.g.*, David Callahan, *Occupy the Tax Code*, THE GREAT DEBATE (Dec. 13, 2011), http://blogs.reuters.com/great-debate/2011/12/13/occupy-the-tax-code/ (arguing that increasing taxes on the wealthy is necessary to reduce income inequality).

rarely a question of entirely eliminating one of the two purposes. Any system of taxation inherently raises some revenue and allocates wealth. The question is whether the redistribution of wealth is a conscious goal of the system, and if so, to what end. Our current system explicitly adopts the wealth-redistribution purpose.[10] This purpose was particularly salient from the 1930s through the end of the 1970s. The 1980s saw a slight retreat,[11] one that lasted with greater or lesser success through 2008, when the ongoing economic crisis hit.

Even with the tax debate as excited as ever, it is not realistic to expect any radical changes to the tax code. Although everyone seems to agree that the code must be "simplified"–and the meaning of simplification of course varies considerably–the two competing purposes will tend to reinforce the present status quo. Government expenditures are addictive. Just as voters strongly dislike Congress[12] but tend to like their congressional representative,[13] so too do most resent a large federal government but hesitate to make substantive cuts. Specific reductions in expenditures are met with fierce resistance by those who benefit from them, whereas the push for tax reform is a very general and diffuse one. The tax code causes someone to lose and someone to win, but no one is ever entirely a loser, because there still remain certain public goods that benefit all taxpayers.

This ratchet makes it easier to increase government spending than it does to reduce it, meaning that there is also a constant upward pressure on revenues that have to be raised to cover those expenses. Because the government does not ordinarily create wealth, it must rely on two vehicles for funding its operations:

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10. Wealth redistribution must to a degree be tied with raising revenue, insofar as distributing wealth to someone requires taking it from someone else through taxation. However, because one of the goals of redistribution is not necessarily to raise revenue but to reduce top incomes, it is not always aligned with efficient revenue-expenditure processes. This makes it at odds with the pure revenue-raising function of taxation.

11. *See, e.g.*, Tax Reform Act of 1986, Pub. L. No. 99–514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

12. *See, e.g.*, Frank Newport, *Congress' Job Approval at New Low of 10%*, GALLUP POLITICS (Feb. 8, 2012), http://www.gallup.com/poll/152528/congress-job-approval-new-low.aspx (noting that 86% of Americans disapprove of congressional job performance).

13. In a September 2010 poll, for example, Congressman John Dingell, whose district includes Ann Arbor, MI, was viewed favorably by 48.3% of his constituents. *See* Ryan J. Stanton, *Latest Poll Shows John Dingell More Popular in Washtenaw County than Other Parts of District*, ANNARBOR.COM (Sep. 20, 2010, 7:24 PM), http://www.annarbor.com/news/latest-poll-shows-john-dingell-more-popular-in-washtenaw-county-than-other-parts-of-district/.

taxation and debt. Taxation is the direct and traditional way to fund expenditures. The government collects tax and then redirects it to its targets. Debt is in principle a stopgap for situations where expenditures exceed revenues. The past several years have seen skyrocketing government expenditures but relatively static tax revenues,[14] leading to a higher proportion of debt. The general sentiment is that running deficits is undesirable.[15] Barring substantive reductions in expenditures, this will tend to lead to a stronger push for raising revenues–through taxation.

WHITHER NOW?

Tax reform is ultimately a political question, and the answer will not come from within tax law. The law can only provide a tool for creating and maintaining a system of taxation. The purposes and priorities are a policy matter. The complexity of the present system reinforces a longstanding policy of wealth redistribution, where all constituencies disproportionately benefit from some aspects, even while many of these constituencies also disproportionately lose from other aspects. This makes coalition building to simplify the tax code difficult, as there is a collective action problem in attempting to seriously do so. Because the system is much more welcoming of gradualism, it is easier for specific constituencies to push for specific redistributive policies and ratchet up the tax code's complexity. In the end, tax lawyers can breathe easier, knowing that they will not be out of a job any time soon.

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14. The Heritage Foundation, *Federal Spending Is Growing Faster than Federal Revenue (Chart)*, 2011 BUDGET CHART BOOK, http://www.heritage.org/budgetchartbook/growth-federal-spending-revenue (last visited Mar. 19, 2012).

15. *But see, e.g.*, Neil H. Buchanan, *Is It Sometimes Good to Run Budget Deficits? If So, Should We Admit It (Out Loud)?*, 26 VA. TAX REV. 325, 326 (2006) ("The belief that it is unquestionably foolish to adopt policies that directly or indirectly increase the government's annual borrowing on the financial markets—which is what it means to run a budget deficit—is not the universal truth that the current conventional wisdom might imply.").