

TOWARDS A CATALLECTIC APPROACH TO TAXING AND SPENDING

by

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Dedication

I dedicate this dissertation to my parents and family. I love you all.

Acknowledgments

While it is my name that is to be officially credited with completing this dissertation, it is by no means the result of my efforts alone, as I am merely the benefactor of the collective efforts of dozens of people who have helped me along the way. First and foremost, I would like to thank my parents, David and Julie, my brother, John, and the rest of my family for their unwavering support during this entire process. Thank you and I love you all.

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Abstract

TOWARDS A CATALLECTIC APPROACH TO TAXING AND SPENDING

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Why are tax policies around the world long, complicated, and rife with loopholes despite virtually universal agreement that a shorter, simpler tax code with fewer loopholes would be preferred? Traditional explanations, which are implicitly grounded in a choice-theoretic framework, are unable to provide an answer to this question. This dissertation seeks to provide an alternative, rules-based approach to answering this question and, ultimately, to answering the question of how taxation and appropriation policies are created.

After an introductory chapter, chapter two identifies two broad strands of fiscal theorizing which date back to the late 19th century in the persons of Knut Wicksell (1896) and Francis Edgeworth (1897). From Edgeworth descends the treatment of public finance as a branch of applied statecraft, as conveyed these days largely through notions of optimal taxation. From Wicksell descends the treatment of public finance as offering explanations for observed patterns of collective activity. These two branches are not so much antagonistic as they are non-commensurable. The explanatory branch, moreover, is underdeveloped in comparison with the hortatory branch, and this paper seeks to sketch some contours for an explanatory theory of collective activity, paying particular attention to the American fiscal context.

Chapter three recognizes that economists have addressed the effect of taxes on a polity,

who then using their findings to justify the implementation of various tax schemes. These theories are loosely based on the ideas of fiscal philosophers from the end of the 19th century, with recent work demonstrating the efficiency gains of optimal taxation theory. These fiscal philosophers, however, almost universally neglect to discuss the implementation of their proposed policies, implicitly believing that politicians will do what is good once they are aware of what is good. Differences in policies among democracies (or differences in the timing of the passage of similar policies), therefore, becomes an explanation of differences in the median voter, which is no different from making a preference-based argument. While plausible, this type of explanation is analytically unsatisfactory. I argue that differing legislative outcomes (of kind or timing) are the result of a difference between the rules the governing body is bound by when proposing and passing legislation. In doing so, this paper pushes back on the preference-based explanation that is prevalent in recent work on comparative public policy and argues instead that the rules of the game matter.

Chapter four seeks to provide a sketch of a micro-level explanation of public finance. De Viti De Marco (1936) and Buchanan (1949) provide initial starting points for understanding this view of public finance, which was subsequently extended by Wagner (1992, 2007a) and Yoon (2000), among others. While these scholars focus on the “fiscal commons” created by communal property rights within public sectors, this paper focuses on the power to tax and provide public goods. Building off of Hebert and Wagner (2014), this paper provides a catallactic explanation of taxation and provision of public goods within the individualistic state, where the state is represented as the sum of its individual members acting in a collective capacity. A concluding chapter, which provides remarks of the project as a whole and its implications for future research and policy, follows.

Chapter 1: Introduction

The central question of this dissertation is “why do democracies around the world systematically choose long, complicated tax codes with several loopholes when a short, simpler tax code with fewer loopholes is virtually universally preferred?” A quick look at tax codes of democracies of varying levels shows this trend to be true: for example, Title 26 of the U.S. Code, commonly referred to as the federal tax code, occupies around 17,000 pages, India has a tax code of approximately 10,000 pages, and the U.K. has a tax code of roughly 11,000 pages. What explains these radical divergences from the preferences of virtually every person?

Current literature explores the creation of tax policy in a choice-theoretic framework, i.e. the explanations can be reduced to saying that some individual chooses among alternative tax policy or actively drafts tax policy. This entity that chooses can be discovered in a myriad of ways, either by direct assignment of the task at hand or through some voting process that determines who the median voter is, but the important point is that the creation of a tax policy can be reduced down to the choice of an individual and can then be analyzed as such. Within this framework, there are three overarching explanations of why a tax policy would be complicated: first, the nature of the task at hand is complicated due to differing elasticities of demand across people, places, and time which necessitates a complicated tax code. Second, governments and businesses are caught in a perpetual game of cat-and-mouse whereby businesses are constantly finding new loopholes (for example, corporate inversion - the act of legally relocating one’s corporate headquarters to a tax haven) which must be closed through the release of technical amendments by Congress. Third, standard rent-seeking stories whereby businesses lobby government to gain political favor that manifests itself in the tax code.

Considering the first case, we can look at Mirrlees (1976) and Stiglitz (1987) especially

for theoretical underpinnings and Gale and Holtzblatt (2000) for a more direct explanation. As Gale and Holtzblatt (2000) puts it, the reason that the tax code is complicated is due to conflicts of other political interests. Virtually everyone agrees with the notion that taxes ought to be “fair, conducive to economic prosperity, and easily enforceable, as well as simple.” The difficulty comes, however, when we recognize that different people have different rankings of these goals. The authors go on to say that the overwhelming majority of countries tend to define tax liability based on characteristics of the individual’s compensation package in an effort to promote a generally recognized notion of fairness. The casualty of this quest for fairness, however, is simplicity of the tax code, especially if we consider that the determination of “fairness” is determined democratically and therefore able to change over time as median voters change.

The second explanation is one based upon the application of technical amendments to fix policies, which can also be found by thinking about the problem of taxation in terms of von Mises (1998b). Several scholars have noted that taxing monetary income, for example, will lead to firms paying more in non-pecuniary benefits.¹ Perhaps the firm will shift from providing a person with dollars as compensation for work done, instead providing them with a company car, phone, house, etc. This becomes especially prevalent at higher income levels, i.e. with people in upper management and board members as their tax burden under the current U.S. income tax code is high relative to lower income families. As companies do this, however, governments then try to find ways to tax these forms of compensation. Taxing property, miles driven via a gas tax, or taxes on investments are all means to accomplish this. This leads people to substitute into yet other activities. Perhaps they will take public transportation or telecommute to avoid paying gas taxes. Companies are also able to avoid paying corporate income taxes by shifting their earnings overseas in a process known as corporate inversion. Here, a company that has a subsidiary branch in a country that has lower taxes or no taxes will invert its operations such that the foreign subsidiary is defined as the parent company and the domestic company is listed as a subsidiary. Fundamentally,

¹See Lewellen (1968) for a summary of this literature.

this does nothing to affect the operation of the business but it can radically reduce the amount of taxes that must be paid.

In this framework, governments pass new tax laws, companies and people find ways around them, and so governments pass new laws in response. Here, the complexity of the tax code can be explained as simply a result of businesses trying to avoid paying taxes and governments attempting to prevent the avoidance (see McClure (1989), Sawyer (1996), Surrey (1969), and White (1990)). With respect to taxes, governments enact a tax policy that leads to taxpayers reacting in unforeseen ways to avoid said tax policy, which leads to new tax legislation designed to address the taxpayers' responses to the previous tax policy. It is fundamentally a story of a struggle between governments and taxpayers, with governments wanting citizens to pay taxes and citizens finding ways to avoid paying taxes.

Finally, considering the third explanation, I reflect back on the logic of Tullock (1967), Buchanan and Wagner (1977), and Tollison (1982). Here, the tax code grows as a result of two separate phenomena, the first being various rent-seeking activities on the part of businesses, specifically the quest to gain tax advantages over other businesses in an industry in order to have a competitive edge over other businesses. Three of the most comprehensive studies of this comes from McIntyre and Nguyen (2000, 2004) and Richter et al. (2009), which demonstrates that strategic lobbying (as opposed to general campaign contributions) does have a robust effect on the tax rates that a company subsequently pays that year, primarily by providing additional tax credits for research and development or through reconfiguring the tax depreciation schedule for specific types of capital equipment. In these scenarios, the tax code would become longer and more complicated due to the increased specificity of the rules, e.g. the rule ceases to be “capital used in productive activities is taxed at this rate” to “capital used in productive activities that meets criteria X , Y , and Z is taxed at rate T ” where X , Y , and Z are various conditions that would have to be spelled out and T is some vector of corresponding tax rates. The mere description of all the combinations of conditions alone would elongate the tax code and the descriptions themselves would need to be clear enough as to render them intelligible.

The second possible avenue in this vein is similar to the logic of Pigou (1928, 1932), in that the presence of a firm generates positive externalities to the surrounding area merely by being there and local politicians use the tax system as a means of internalizing those externalities as a Pigouvian subsidy. Alternatively, this line of reasoning can be explained using logic similar to Benjamin et al. (1990), Pashigan and Gould (1998), and Gould et al. (2005) in that these stores are analogous to the anchor-stores in malls and thus should pay lower rent due to their ability to attract customers. This line of reasoning, though, accepts the old Oliver Wendell Homes line that “taxes are the price we pay for a civilized society,” which currently adorns the entrance to the IRS headquarters. Here, the tax code grows as a result of describing which firms get what tax break and what form those tax breaks will take as a means of internalizing the positive externalities on job creation, economic activity, etc that they create. The bigger this impact, the more of a discount on their taxes these firms should receive.

To be sure, the choice theoretic framework has analytic tractability on its side. However, these explanations of observed political outcomes ultimately fail to get at the *why* tax policy is particularly likely to be complicated. Other forms of legislation, for example, are comparatively short and simple. Further, private organizations behaving in much the same way as governments (churches, clubs, scout troops, etc) often do not have complicated rules governing who owes how much in dues. To address this, I look at more recent work by Wagner (2007a, 2009, 2012) and Yoon (2000), who take a more catallactic approach to understanding political outcomes, emphasizing the role of common property rights and the fiscal commons. In doing so, this research applies what may be considered a cousin to Hayek’s spontaneous order theorizing in that the resulting tax policy is not the creation of any one person but instead the result of several people working together within a framework of rules, contributing small amounts of knowledge towards the final product. It is this framework of rules, which often lie below the surface of consideration pursued by scholars engaged in choice theoretic explanations, and the interactions of the people involved within these rules that ultimately determines political outcomes. By reducing the act of creating

a tax policy to the choice of a single entity, the choice theoretic frameworks fail to accurately depict the world and, as a result, produces explanations that are left wanting. Understanding this point is key towards understanding why policy is what it is today.

Chapter 2: Taxation as a Quasi-Market Process – Explanation, Exhortation, and the Choice of Analytical Windows

What is the place of economic theory in the analysis of fiscal phenomena? We think a reasonable answer is that there are two such places and not one. One place treats the object of analysis as applied statecraft, whereby the analyst seeks to advise politicians about the desirability of different tax systems and fiscal programs. Here, public finance is fundamentally a normative branch of economics. As Mankiw, Weinzierl, and Yagan (2009) explain in their examination of optimal taxation, there are points of contact between the claims of the optimal tax literature and the features of actual tax systems, though there is also a good deal of divergence. The other place where economic theory can be brought to bear on fiscal phenomena is explanatory rather than hortatory in nature. This explanatory approach to public finance inspires this paper.

The aim of this treatment is not to offer rankings of tax programs against some normative standard. It is rather to offer explanations of observed fiscal reality within the same analytical framework as employed in the analysis of market interaction, suitably modified to take into account institutional differences between market and collective processes of human interaction. Both market and collective processes entail competition among entities organized inside the precincts of economy and polity respectively, and with all participants operating with local and not global knowledge. Within this orientation, tax policy is concerned with generating revenues to support the collective activities that are the sources of livelihood for various politically-sponsored enterprises. Tax policy within a polity is comparable to price policy within market-based enterprises. In both cases, going concerns must generate a sufficient stream of revenue to maintain their going status. The explanatory

branch of public finance seeks to explain how tax policy emerges out of this process for generating collective revenue, in contrast to treating tax policy as an instrument for maximizing some notion of social welfare. Whatever normative properties that process might have is of secondary interest to this line of examination, in contrast to its primacy of interest within the domain of hortatory public finance.

2.1 Welfare Pricing and Public Finance: A Review of Options

The roots of the theory of optimal taxation reside in Francis Edgeworth's (1897) formulation of the problem of a ruler who wants to raise a given amount of revenue in a manner that minimizes the loss of utility his subjects suffer. Edgeworth assumed that people could be reasonably characterized as having income-utility schedules where utility increased with income at a diminishing rate. If rates of tax had no effect on supplies of effort, optimality required a paring down of incomes from the top. With a sufficiently large amount of revenue to be raised, full equality in the post-tax distribution of income would result. Edgeworth also recognized that such a scheme of taxation would weaken the incentive to generate income, which would reduce the extent of post-tax equalization. Edgeworth's formulation set in motion the subsequent hortatory treatment of public finance as concerned mainly with aggregate welfare maximization through redistribution.

In this respect, Ramsey (1927) initiated the ideas that became optimal taxation when he posed a ruler's problem of minimizing the excess burden of taxation. Mirrlees (1971) continued and extended this line of thought by posing the problem of using the budget as a device for maximizing social welfare. This scheme of thought creates a disjunction between market activity and fiscal activity. Market activity is the domain where the first draft of the manuscript of social life is created. That manuscript is then perfected through utilitarian-inspired collective redistribution to increase aggregate utility as the theorists conceptualized such utility. As Mankiw et al. (2009) explain, there is clearly some matching

between optimal tax claims and observed taxation, though there is also divergence. Perhaps that divergence points to areas for analytical improvement that, once created, will reduce the divergence between the claims and the reality, under the presumption that the theoretical recommendations are compelling within the political arena in which they are offered. Alternatively, that divergence might point to limitations of the analytical framework with regard to the actual organization of collective activity.

Optimal tax theorists typically treat tax policy as the creation of some enlightened fiscal philosopher. While fiscal philosophers have developed a number of formulations of efficient, just, or optimal taxation over the years, they share an underlying structural simplicity. The simplicity of the conceptual formulations would seem to clash with recognition of the complexity of actual revenue systems. To be sure, this divergence between theoretical simplicity and actual complexity might be explained as an ordinary consequence of the theorist's abstraction of some fundamental qualities from the messy realities found within the world of practice. We don't doubt that practice is messier than reality. This is always the situation when a theory is compared to the reality to which the theory is thought to pertain. It couldn't be any other way.

At the same time, however, we wonder whether the theorist's drive for simplicity and tractability might end up setting aside from theoretical consideration some significant features of the reality to which it is thought the theories pertain. In this respect, we would recall Knut Wicksell's (1896) lament that the theory of public finance still rested on an outmoded presumption of political absolutism. If it were thought that fiscal choices were made by some royal personage or median voter, it would seem reasonable to theorize about those choices from the standpoint of a fiscal philosopher. But if fiscal outcomes, including tax policy, emerge out of a process of political interaction that is cousin, perhaps a distant one, to a market process, it would seem worthwhile to theorize about the operation of such a process with respect to tax policy.

For instance, Wicksell (1896) sought to articulate an institutional framework for the Sweden of his time that would create formal congruence between fiscal and market outcomes.

As Wagner (1988) explains, Wicksell sketched an institutional framework for collective interaction that he thought would reflect individual wants for collective services in the same fashion as market outcomes reflected individual wants. One feature of Wicksell's framework was a proportional system of representation with a sufficient number of parties to make it reasonable to think of the Swedish parliament as a miniaturization of the Swedish society. That parliament would operate with a high degree of consensus so that agreement within parliament would translate reasonably well into agreement within the society that was represented through parliament. In place of ordinary bureaucracy; moreover, parliament would face an entrepreneurial monarch who was a residual claimant and earned a livelihood by selling proposals to parliament. The logic behind this institutional scheme is that taxing would be a means of collective pricing, and with the requirement of near-consensus operating to render taxation as a means of pricing collective activity, as distinct from taxation as an instrument of despotic manipulation, whether benevolent or otherwise.

Within this institutional scheme, collective pricing would have the same emergent and complex quality as market pricing. In this respect, it is worth noting that the revenue code of the American federal government occupies some 50 volumes covering over 17,000 pages and including nearly 4 million words. No member of a revenue committee could read the tax code, let alone read various professional commentaries on aspects of the code and possible revisions to the code. The tax code is assembled through interaction among many people extending over a good number of years, and will continue to be assembled in this manner. The tax code has elements of a market process, in that it entails the use of distributed knowledge that is in no person's possession. The basic claim of market theory at least since Hayek (1937, 1945) is that market processes tend to generate coherence among activities and prices even though no one possesses the knowledge necessary to orchestrate that coherence. Tax policy, we submit, has a similar market-like quality, as we try to sketch in this paper. We shall explore some of these similarities in tacking back and forth between theoretical formulations grounded in simplicity and the practical politics of tax policy.

2.2 Putting This in Perspective

If we imagine a well-intentioned politician in the image of de Jouvenal's (1961) image of the well-intentioned parliamentary chairman, what would it take for him to actually read and comprehend the issues in a proposed piece of tax legislation? For simplicity's sake, we assume that all that the politician has to do is read the page once and that he reads at an average reading speed of 250 words per minute, or about one page every two minutes.

First, our politician would have to read the bill. The average piece of tax legislation introduced before Congress in 2013 is roughly sixty pages which would take just over two hours for our politician to read. In addition to the actual legislation, he would probably want to read the testimonies of the various experts at the committee hearings that are relevant to the bill. Most hearings have between five and seven experts that testify, who give testimonies that are about thirty pages long. This adds another five to seven hours of reading time per hearing that the politician finds relevant.

While it remains purely speculative as to how many hearings a politician may find relevant, we feel reasonably confident in saying that it is more than one if only because multiple committees typically hold hearings covering the same issue. The Ways and Means Committee, for example, may hold one meeting covering the effects of offshore tax havens while the Joint Committee on Taxation might hold a separate hearing on the same topic with different experts. However, we will assume that our well-intentioned politician only finds one committee's hearing worthwhile.

Once he has read the bill and the testimonies of the experts, he may also want to read the transcripts of the hearings to get a sense of what questions came up and were addressed previously. These weigh in at about eighty pages each, adding another roughly two and a half hours of reading time. Finally, our well-intentioned politician would also want to look at some of the various reports and publications that the committees routinely put out. These typically have anywhere between twenty and sixty pages as well, adding roughly another one to two hours of reading time per report that he reads.

All told, our well-intentioned politician has at least three hundred and thirty pages

of reading to do per bill assuming that he only goes over the material presented at one committee hearing and in one committee report, which would take a person with an average reading speed about eleven hours of reading time. We would find it odd that only one hearing's worth of material was relevant for the bill being considered relevant, but this is only meant to establish an absolute minimum. In actuality, it could easily be the case that several committee hearings and reports are relevant, quickly multiplying the amount of reading time necessary to comprehend a bill. We can also imagine our well-intentioned politician wishing to consult materials from outside of these settings (perhaps academic research on the topic) that would also quickly increase the amount of time necessary to comprehend each bill.

This also assumes that our politician spends his time considering only that one bill and nothing else. In reality, politicians are constantly busy, getting pulled into meetings with various other politicians and constituents or traveling back to their district to meet with their constituency. Clearly, this is an untenable situation for our politician - he is, after all, but one man.

What he must do, therefore, is hire a staff of workers to work with him. The people directly responsible for helping him to navigate the jungle of research necessary to consider for each bill are his legislative aids and legislative director. These workers generally handle most of the reading for the congressman and then brief him of their findings in a meeting before the vote takes place.

While the amount of reading for one bill may seem insignificant, we should also keep in mind the volume of bills that get voted on each year. In the case of the 111th Congress (the most recent Congress for which data is available), this amounts to 6,677 bills introduced before Congress with 861 ultimately passing. In addition to this, there were also 1,384 committee hearings. While this may seem like a lot, it is actually significantly lower than the average over the last fifty years. The average number of bills introduced into Congress per congressional session between 1949 and 2011 (the years that the data is available) was 10,975 of which on average 1,101 passed, and there were 4,389 committee hearings. To put

this in perspective, to read all of these bills would require a staff of over fourteen people reading twenty-four hours per day, every day, for an entire year. This is clearly untenable, meaning that there must be some process by which this reading gets distilled into a more manageable size to handle. To offer precise detail regarding this process by which the reading is culled is beyond our ability to discern because idiosyncrasies among legislators surely come into play. Some congressmen and their staffs might give primacy to things that comport to some ideological beliefs they hold dear and which resonate strongly with their constituents. Other congressmen might give primacy to significant campaign contributors and other supporting interest groups. Yet other congressmen might make some random choice among the potential readings. Regardless of the particular approach a legislator might take, he or she will do so in the face of limited knowledge if only because of the sheer volume of reading that comes out every year when time is absolutely inelastic.

2.3 The Centralized Mindset in the Context of Explanatory Public Finance

Mitchel Resnick (1994) observes that it is common to attribute observed macro-level patterns to some order-imposing agent even though no such agent is actually at work in generating that order. Resnick applied this insight to such phenomena as the flight patterns of geese or the gathering of food by ants. But the same claim can be brought to bear on such fiscal phenomena as patterns of taxation. A particular scheme or pattern of taxation is observed, and is attributed to some act of choice, either real or virtual. For instance, the observation might pertain to some set of progressive tax rates on income, and those rates could be described as the solution to an optimization problem for some agent. This agent could be designated as a ruler or policy maker within the spirit of optimal taxation. Alternatively, it could be designated as the preferred tax structure of a median voter within a framework of electoral competition, as illustrated by Hettich and Winer (1999).

What would happen to the explanation of taxation if the centralized mindset were

abandoned? It would now be necessary to explain tax structure as a product of interaction within some framework of rules that govern relationships among those who participate in making decisions about taxation. What would be some of the elements of such an explanatory approach to taxation (or public finance generally)? We will confine ourselves to democratic systems where taxation and budgeting is the province of elected officials. Legislative assemblies are an intermediary that connect people who are seeking support for enterprises they favor with people who have the means to support those enterprises. In this case, those with the means of support are taxpayers, and politicians impose taxes to finance the enterprises they want to support. We would avoid the centralized mindset by noting that politicians differ among themselves in the extent to which they would like to see different enterprises supported. Taxation, in other words, is one side of the fiscal process, the other side of which is appropriation. Taxation is the prime means by which political entities derive revenue to support their activities. Maffeo Pantaleoni (1911) explained that political entities are supported in parasitical fashion through their connections with market enterprises. With limited exception, political enterprises do not support their activities from prices charged to customers. While it is often claimed that this inability to obtain revenues from customers is a technological feature of the public goods nature of governmental activity, this claim, while not empty, has only limited applicability in light of numerous contrary observations where public goods are financed through market transactions. Two widespread illustrations are malls and hotels, both of which provide tied packages of public and private goods and which are explored by MacCallum (1970), Foldvary (1994), and Wagner (2011).

These institutional arrangements create a problem of misidentification where the public good disappears from sight and the service is treated as wholly private when it is not. Hotels provide public goods as well as private goods. They provide subways that run vertically. They provide parks, some quite elaborate, and one even offering skiing, while others are small and cramped. Hotels provide street (corridor) lighting and refuse collection. These public goods can be provided in different qualities, and with hotel owners reasonably thinking they face tradeoffs between the cost and quality of those public goods and the

revenues they are able to derive from their supply of such private goods as rooms. It's the same with malls. Some offer few public goods other than open access parking and some park benches. But some offer quite elaborate public goods, extending to such things as zoos and museums.

These hotels and malls provide public goods, but finance them by tying their provision to the supply of private goods. Malls, moreover, often use a cousin of taxation by charging rents that to some extent are a percentage of gross sales, thus mirroring a sales tax. In any case, public goods are often provided through market transactions in a tied-sale manner, which operates against any facile presumption that technological conditions prevent the pricing of public goods. What seems to be more in play are the various institutional arrangements through which collective supply is undertaken and not some technological distinction between private and public goods. Within governmental entities as they are presently instituted, though not universally throughout history as the feudal experience illustrates, political entities derive revenues in parasitical fashion from attachment to market enterprises and activities.

Suppose we think of taxation as a two stage process, and with those two stages reflecting two different aspects of human mentality or valuation. One aspect is some recognition of a sense of common interest in some set of activities that reflects the problems of living together in close proximity, as illustrated by De Viti de Marco's (1936) recognition of public wants as wants that arise in consequence of people living together in close proximity. In other words, a desire for public goods, which is distinct from a desire for governmental activity per se, resides in human nature and comes into play as population density grows. The other aspect is individual partiality for one's own preferences and values, as well as a robust ability to rationalize one's own exceptional qualities, which was a central theme of Pareto's (1935) analysis of the operation of non-logical action within political and social processes. Where the first aspect provides the ground for some general acceptance of taxation, the second aspect provides the ground for what seems to be the nearly limitless extension of special provisions, exemptions, deductions, and exceptions that serve to create tax complexity as a

by-product of the natural recognition that the best tax is nearly always one that someone else pays. This dualism provides an explanatory framework for taxation without recourse to normative stipulation as to what constitutes desirability or optimality in taxation.

2.4 Stage I of a Two-Stage Scheme of Taxation

The existence of a collective entity, at least of democratic form, surely entails some general recognition of matters of common interest that may entail some willingness to contribute to the support of collective activities. People may well differ in their intensity or desire for such collective provision. In this respect, De Viti de Marco (1936) operated with a presumption that individual evaluations for such collective activity rose in proportion to income. In this vein, Buchanan (1964) extended De Viti's framework to explain that under such circumstances a flat-rate income tax would lead everyone to support the same quantity of public output: the amount of public activity demanded would rise in proportion to income, but the tax price paid per unit of public output would rise at the same rate. Hence, the income and substitution effect would cancel and would leave all members of the collectivity agreeing on the same quantity of collective output.

This Stage I is, of course, an imaginary construction that serves as a foil for our examination of what we conceptualize as Stage II. That construction is meant to convey recognition that the living together of people in close proximity generates what can be described as a demand for collective-type activity. This recognition need not result in collective production, but it could. In his study of English town government in the 16th century, J. H. Thomas (1933) noted that a universal desire that garbage not accumulate in yards led originally to a system where carters would contract with households to cart garbage to dumps. Sometimes carters wouldn't go all the way to the dump before dropping their load, and in the technology of the time it would be hard to determine who was responsible for the garbage deposited in the street. What came to pass was town takeover of refuse collection, with payment to the town replacing payment to individual carters. While the town bureaucracy might perhaps be less efficient technically than private carters, it would also be clear

who to blame for mislaid garbage. The general interest within the society that garbage be carted away rather than accumulating in yards is independent of the institutional means by which such carding is accomplished. In this setting, Stage I is meant simply to assert that there is some latent demand for common provision that would be generally agreeable within a society. Stage I by itself would be a model of tax simplicity. It would be a tax that would entail a form the size of a postcard, along the lines that Hall and Rabushka (1983) sketched. Actual income taxes are nothing like this, of course, which brings us to Stage II of our analytical scheme.

2.5 Stage II of a Two-Stage, Polycentric Scheme of Taxation

Where Stage I allows a tax return the size of a postcard and would have a similarly small tax code, Stage II generates a tax code of some 50 volumes along with a small industry of tax experts who advise people on how to arrange their affairs to lower their tax liability. It is in Stage II where the real business of taxation occurs, including use of the threat to tax as a form of rent extraction (McChesney, 1997). Stage II is where the tax code lengthens and becomes more complex, as illustrated by such things as imposing a tax on medical devices, increasing the threshold for the deduction of medical expenses, or increasing the tax on withdrawals from health savings accounts. These and the thousands of similar cases in play each year all involve negotiation and bargaining among legislators and affected parties, and collectively exceed the analytical grasp of any individual legislator.

With multiple legislators vying to accomplish various and often contradictory goals through the use of the tax code, a certain degree of incoherence, as Paul (1997) refers to it as, will result. This is because there ceases to be one, overarching goal that the tax code is meant to attain. In its most obvious case, taxation is being used as a form of collecting revenues to finance the operation of governmental entities. But others wish to use the tax code to accomplish other goals as well. For example, taxes on tobacco products or alcohol are used as a means to curb behavior that some officials in Washington D.C. would like to see less of. Here, the goal is not to raise revenue but instead to nudge people

to behave in ways that reduce costs for government in other areas. Ahmad and Franz (2008) claim that government officials can use taxes to reduce the incidence of smoking, thus saving the federal government \$317 billion in subsidized medical costs. Alternatively, perhaps government officials just want to see less smoking. In either case, this can be (and is) accomplished by raising taxes on smoking. Or perhaps politicians use taxes to reduce pollution, as Pigou (1932) suggests. Each of these represents a different and competing use of the tax code.

In this stage, politicians are working to try to accomplish the many goals of their constituents while also advancing their personal and political goals. Here, the length of the tax code grows beyond fitting on the back of a postcard as in Stage I simply because of the myriad goals that the tax code is being used to accomplish. What changes can be made, when they can be made, and by whom they can be made, however, is a function of the rules that politicians face, which brings us to discussing how a tax code actually gets changed.

2.6 Process of Changing a Tax Code

We shall confine ourselves to describing the U.S. system not because it holds any special place as a tool for analysis but simply because this is the system with which we are most familiar. The underlying theory, however, can be applied to any and all democratic settings with but minor changes. In order to have an explanation of where tax policy comes from, we must explain the process by which a well-intentioned politician would set about enacting tax policy. To start, we must acknowledge, as several scholars before us have done, that government is comprised of thousands of people working jointly on various tasks. Groups cannot make decisions outside a framework of rules that frame what can and cannot be done and the process by which what can be done is done.

To participate in tax legislation requires first of all obtaining a seat on the House Ways and Means Committee. This is accomplished by first submitting a list of preferred committees to the Committee on Committees. This Committee then matches the politicians according to the seats that are available. Once this slate has been put together, it must

be approved by the entire party and then by the entire House. Once a legislator is on the Committee, he becomes the lowest ranking member by seniority. In this capacity, he is extremely limited in what he is able to do, if only by informal convention. In order to really have any ability to shape policy that is being drafted, he would have to become the Committee Chair or Ranking Member. This is typically accomplished by being the most-senior member of the committee of his particular party, with the difference being determined by the overall composition of the House. Should his party be the majority party, he becomes the Chairman. If the minority, he becomes the Ranking Member. By convention, the Chairman and the Ranking Member work jointly to propose bills but the Chairman ultimately has the final say.

The House Ways and Means Committee is then divided into several subcommittees, each of which has been given a task of thinking about one particular aspect of the proposed tax plan. The subcommittee on health, for example, has jurisdiction over all matters related to payments for health care, including tax credits and deduction provisions. The subcommittee on human resources has jurisdiction over issues related to childcare and family services. The subcommittee on social security has jurisdiction over retirement, survivors, and disability programs as well as employment taxes. Finally, there is also the subcommittee on trade, which has jurisdiction over tariff and import fee structure, including classification, valuation of, and special rules applying to imports and exports.

In addition to these specific subcommittees, there are also two subcommittees that are more general. The subcommittee on select revenue matters has jurisdiction over things that the Chairman of the committee decides to give them jurisdiction over. This can be as narrow as investigating the IRS for cases of inconsistencies to as broad as the increased prevalence of part-time employment. Finally, there is also the subcommittee on oversight, which has concurrent jurisdiction over 'all matters within the scope of the full committee's jurisdiction but shall be limited to existing law.' This means that this subcommittee cannot propose new legislation of its own, but rather can work jointly to investigate existing legislation with the appropriate subcommittee.

When crafting a new tax policy, each of these subcommittees works on their assigned part of the bill separately from the full committee (though the members of the subcommittees are a subset of the members of the full committee) with each part being broadly guided by the wishes of the Chairman. Here, we are reminded of the (likely) process by which software engineers working in large software companies create programs. Certainly no single person created Microsoft Word, but rather teams of engineers each wrote specific aspects of the code and someone compiled it all together into the program with which we are all familiar. Perhaps one team was in charge of writing the code for handling footnotes, another was put in charge of highlighting and various other font/style changes, and another still was in charge of the equation editor. No matter how specific the directions, there is bound to be some scope for ingenuity or creativity in the coding of a program such as Microsoft Word. As a result of this, stitching the code together at the end is more analogous to the creation of Frankenstein's monster in Mary Shelley's classic 1818 novel than the creation of, say, a family dinner. Some parts will fit together imperfectly and workarounds will have to be devised. In the software world, these workarounds are commonly described as 'software patches.' Whenever a flaw is discovered in software, typically the developer will release a downloadable software patch designed to correct this flaw. While software companies such as Microsoft certainly have an incentive to find and fix these flaws before they are released, some flaws nonetheless escape their watchful eyes (writing this sentence prompted one of the authors to check for software updates ' he found that there was one waiting to install).

Tax policy similarly has a Frankenstein's monster-esque quality to it. The various subcommittees work on their individual parts of the bill that are finally stitched together when all the parts are brought together before the full committee. The resulting tax proposal becomes an amalgamation of the various goals and aspirations of the various politicians involved in writing the proposal. The difference here, however, is that the exceptions to the rules do most of the work in a tax policy and (hopefully) zero of the work in software code. A tax policy that says something to the effect of, 'everyone must pay taxes' is usually qualified by a statement such as 'except in the case that' after which there would be several

items excepting an individual from paying that particular tax. These may be things like having a certain number of children in college, income below a certain level, or being of sufficient age.

What should be clear by now is that to treat the proposal as the “Committee’s proposal” is a fictional statement. Doing so is to commit what Resnick (1994) describes as the centralized mindset that dominates the hortatory public finance literature today. To this end, we’re reminded of three classic examples of spontaneous orders within the economics literature: Woolen coats get constructed (Smith, 1776), Paris gets fed (Bastiat, 1964[1848]), and pencils get made (Read, 1996), despite no single person being in charge of these activities. Individuals act within these production processes on the basis of personal and local knowledge to pursue projects that interest them. This pursuit requires the cooperative participation from other people who similarly are pursuing projects of their choosing. Describing the market not as a physical place but rather as a process of exchanges represents economists’ efforts to explain how orderly patterns of activity arise and change without there being any person or office in charge of that activity.

2.7 Conclusions

While this essay looks only at the initial phase of designing a tax policy at the very beginning of a long process, this alone should provide a greater understanding of the complexity of the process of crafting new tax legislation and how it is not simply the product of one, centralized mind. A complex process need not result in a complex policy. Country clubs, for example, typically have a complex process by which dues can be altered, frequently requiring approval of the club’s owners, board of directors, and membership before a vote can even be put forth. And yet the resulting rule is very clear and very straightforward. Private insurance companies face a multitude of customers, each of whom is unique and yet while the rules governing who pays how much are complicated, they are tractable and coherent. Governments around the world have passed laws governing traffic patterns, getting down to fine levels of detail with respect to what colors can be used for what purposes on signs.

And yet the rules are still very easy to follow. So the key variable cannot be the fact that a group is making the decision nor can it be simply explained as the nature of government per se. Rather, there must be something unique to governments passing tax legislation that necessarily leads to a complex policy.

We posit here that there is a type of two stage process, which starts with recognition that a society will have some common wants that will entail some willingness to contribute to the support of collective activities. This, in turn, will require some degree of payment that may look like taxation. But this type of taxation, we imagine, would be simple enough to fit on the back of a postcard. Stage II, however, is where we recognize that citizens will claim some degree of exemption from taxation and at the same time politicians will recognize that the tax code can be used for several alternative means. It is here that a tax code in a democratic society evolves from being simple to one that is complicated enough to spawn an entire industry dedicated to navigating its labyrinth. What the resulting tax code looks like, however, is largely a function of the rules a politician faces when trying to create a tax code.

Chapter 3: Rules Rule - How Different Rules Lead to Different Tax Policies

3.1 Introduction

Most people would agree that the job of politicians is to pass legislation that governs the behavior of people within their polity. These rules can be things as benign as which side of the road to drive or the legal drinking age to how much school a person is required to attend. To finance these operations, governments must collect taxes. But given that every state wants to raise revenue, what accounts for the widespread differences in tax policies across nations?

With the idea that there were public goods, the idea that they would be systematically under-provided on the market came to dominate the political and economic discourse. To get around this problem, government was charged with providing these goods as they alone had access to the legitimate use of force that could be used to collect payment for the provision of these goods. While intuitively simple, this presented a problem in that it was not clear how much each person should pay. Should a wealthy person and a poor person have to contribute an equal number of dollars (or other currency) or should they have to contribute an equal share of their income (similar to tithing 10% in the church)? Perhaps the rich person should have to pay a greater share of his income while the poorer person a lesser (a progressive income tax)?

To settle this debate, society turned to what might be called the fiscal philosophers; people who combined economics and ethics, who divined that the best tax system was one that provided the greatest social benefit at the lowest social sacrifice.¹ Taken at face value, this proposition should sound appealing to all people, economists alike. How could one

¹See Wicksell (1958), Sax (1958), Lindahl (1958), Pigou (1928), and Mirrlees (1971)

argue against maximizing benefits and minimizing costs? The underlying logic, therefore, is that politicians need only be informed of what policy will accomplish this and they will then go out and implement it without haste.

Unfortunately for the fiscal philosophers, tax policy must be implemented by fiscal realists, e.g. politicians. Depending on their jurisdiction, these politicians are bound by different rules for proposing and passing tax legislation. This can be exemplified by comparing the process of passing a tax policy in the United States with that of the United Kingdom. Both polities are essentially democratic in nature and yet the tax policies passed are very different. These differences can be explained in one of three ways:

Assuming that politicians all genuinely want their constituents to live healthier and wealthier and that politicians therefore only propose good policies, differences in the final tax policy or in the timing of the policy's implementation across democratic polities, therefore, is explained by differences in the knowledge of what fiscal philosophers deem to be a good policy. To put this another way, fiscal realists in some parts of the world may not have access to the works of the fiscal philosophers in others and therefore simply do not know what the right thing to do is. With the rise of technologies such as the printing press (let alone the internet!), this explanation seems unlikely.

In democratic elections, it is the median voter that gets what she wants. Perhaps the difference in tax policies can be explained by differences of the respective median voters. This is plausible, but in economics we typically shy away from arguments based on preferences (see Stigler and Becker (1977)). This is not to say that preferences are not a real thing (they most certainly are) nor is it meant to say that preferences don't matter (they most certainly do), but explaining different results as a matter of different preferences is a very weak argument as it can explain anything and therefore nothing.

Alternatively, one could explain the differences as a result of the different rules of the game whereby the same players operating under different rules produce different outcomes. In this sense, we can think of an analogy to sports. Taking Michael Jordan and Phil Mickelson and putting them on a golf course will yield a very different sort of competition

than if we put them on a basketball court. The key difference between these environments is not the players, but the rules. In one scenario, they are playing golf, which has as its objective getting a ball into a hole. In the other, they're playing basketball which also has putting a ball in a hole as its goal. However, as should be clear, there are very different rules in each of these games which affect the strategies that the players undertake. This final theory, it seems, is the more analytically fruitful activity and it is this theory that will be pursued here.

In doing so, this paper contributes to two strands of literature. Primarily, the comparative public policy literature, such as Marsh and Olsen (1984), Campbell (1998), and Pierson (2000) and is most closely related to the work of Sven Steinmo (see Steinmo (1989) and Steinmo and Watts (1995)). It also contributes to the recent literature on public choice that views politicians as acting continuously within a complex network. See, for examples, Wagner (1992, 2007a, 2009, 2012), Marlow and Orzechowski (1997), Yoon (2000), and Buchanan and Yoon (2001).

The rest of the paper will proceed as follows. Section II provides a brief review of the current approaches to analyzing differences between political outcomes. Section III puts forth the notion that the rules matter and provides a cursory overview of the rules of two different political systems: Congress in the United States and Parliament in the United Kingdom. Saying that the rules matter is one thing; demonstrating that they matter is another. Sections IV and V provide evidence that the rules do, indeed, matter. Section VI provides concluding remarks.

3.2 Where We Are And How We Got Here

When comparing the policies of different countries, social science has typically left this to the realm of the political scientists. Theories abound as to why policy issues differ markedly from nation to nation, but they can be readily grouped into two categories: interests and

values.²

Explaining the differences between policies across countries by “interests” is arguing that there exists political power that is distributed across various groups within society. Differences in policies across countries, therefore, are explained by differing distributions of this political power.³

Brader and Tucker (2012) illustrates how “the power of partisanship [shapes] voter preferences” by looking at Great Britain, Hungary, and Poland. Using survey experiments, the authors find strong evidence that “party identifiers often follow their party’s lead when expressing policy preferences.” Hicks (2013) describes the difference between health systems in the UK and Sweden post-World War II as being driven by a difference in political power, saying that the British Labour Party, while weak, was “constrained such that it could only pursue redistribution via health policy” while in Sweden, the Labour Party was able to use its political power to design the system to be “difficult for future Conservative governments to retrench.”

Values, or more loosely, cultures are thought to be another source of differences of cross country policy differences. In describing the value theory, King (1973b) provides a clear explanation, saying that scholars “know quite a lot about decision-making processes in individual countries, [but] not nearly enough about why the governments of different countries make different decisions and pursue different policies.” His analysis is focused on the countries of North America and western Europe, describing what the state does in each country and how they do it. King (1973a) then continues the analysis and provides an explanation as to why the United States differs from the western European countries more than the western European countries differ from themselves.⁴ King points out that the theory that

²This section is meant only to give a brief overview of what “comparative public policy” is. For a summary of the history of thought of the Comparative Public Policy, see Heidenheimer (1985).

³For a review of the classic literature on this specific aspect of comparative public policy, see Wilson (1983).

⁴It’s worth noting here that this is also the underlying theory behind “American exceptionalism” as laid out in Hartz (1991 [1955]), where the United States is successful not because the U.S. is intrinsically better than the rest of the world because of some special endowment of resources but rather because of some qualitative difference about the people, primarily that the Founders were fleeing persecution from the state and thus set up a free society.

America is different from the other countries because of the ruling of some “elite class” that prefers to keep government small is “not very plausible.” He next considers differing institutional barriers (checks and balances, for example) as an important consideration for policies but dismisses them out of hand as “they can be surmounted.” He concludes, therefore, that it is the ideas that matter, saying “the ’plays a more limited role in America than elsewhere because Americans, more than other people, want it to play a limited role.”

More recently, scholars have picked up on this notion and ran with it. Day and Klein (1987) provides evidence that countries have different values by looking at the public provision of nursing homes. The authors compare nursing homes found in various countries around the world and explain that the reason why the nursing homes in the U.S. are generally privately run is because the people there simply do not want government involved in this business. They are quick to point out, however, that the rapidly changing technology of taking care of people seems to be leading towards convergence across countries to some standard level of care for the elderly. The conclusion, therefore, is that the end result (care for the elderly) is actually independent of the institutional context within which the business is operating. Lieberman (2002) explains that it is the intersection of ideas and institutions that drives political change by looking at the progress of the American Civil Rights movement, especially on racial issues.

Emmenegger and Klemmensen (2013) evidences different countries’ values mattering for policy outcomes by looking at the redistribution and immigration policies of countries around the world. Countries that are pro-redistribution are thought to be societies that exhibit a lot of “caring” for their fellow man in general. Countries that therefore redistribute large portions of wealth among their citizens but actively prevent foreign citizens from immigrating are explained as having a preference for defining their fellow man narrowly as opposed to broadly, after controlling for the costs of redistribution (e.g. population growth).

The trouble with these explanations is that they stop their analysis short of a truly satisfactory explanation. It is one thing to note that there are differences across countries in terms of the policies that they pursue to solve the different problems that plague them.

It is quite another to explain why they pursue different policies when both are facing the same problem and want the same result.

The closest approach to what is being pursued here would be the existing literature on various voting models and how those can affect the final outcome of a vote. For example, a simple majority as Condorcet proposed may, under certain conditions, generate a different outcome than would appear in a Borda count voting scheme. The reader is invited to review various voting models found in existing literature at their leisure for more on this.

This approach has an advantage over the existing comparative public policy literature in that it can explain different political outcomes among completely identical agents who are choosing between identical options with identical goals. This is indeed a powerful and very useful result. However, it cannot explain why the options may differ among identical agents with identical goals operating within an identical voting model, as is the case when we look at tax policy passed in the U.S. under Reagan and the U.K. under Thatcher. While not completely identical, Congress and Parliament are arguably similar enough. Both are bicameral in their nature and both operate under a simple majority vote system to pass legislation that must then be signed into law by one person who has veto power.

3.3 The Light of Basic Public Choice

As Brennan and Buchanan say:

The same individuals, with the same motivations and capacities, will interact to generate quite different aggregate outcomes under differing rules, with quite different implications for the well-being of every participant.

-(Brennan and Buchanan, 2000, pg. 4)

The reason behind this is simple: the rules of the game shape the options that people are allowed to pursue.⁵ Put differently, when attempting to accomplish a given end, the means

⁵more accurately, they affect the relative costs of various strategies by penalizing or rewarding certain behaviors. Murder is illegal, for example, but there are still murders occurring. See Becker (1968) for more on this.

available to accomplish that end are determined by the rules that the person is operating under. Different rules, therefore, allow different means which leads to different outcomes. While Brennan and Buchanan were explicitly talking about the private, market setting, their insight can readily be applied to the political realm as well, as Wagner does, saying:

This is not to deny that the selection of one candidate over another might make a difference...; it is only to assert that typically it won't matter a lot. Parliamentary assemblies are best modeled as networks of relationships among the members of the assembly. Changing the identity of one holder of a nodal position in that network will generally exert some modest influence over parliamentary outcomes.

-(Wagner, 2012, pg. 69)

To illustrate this, we can look at the different rules governing the proposal and subsequent enactment of tax policies of the United States and the United Kingdom. Each one will be considered in turn.

3.3.1 The United States

In the United States, the power to tax is explicitly granted under Article 1 Section 8 of the Constitution, which says:

The Congress shall have power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

The process by which these bills are to be proposed and then enacted is outlined in Article 1 Section 7, which says that “all Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills.” What this means is that all schemes for raising any revenue must originate in the House but, once it has passed the House, the Senate has the authority to propose

amendments to the House version of the bill. Alternatively, they can pass the House version as is (in which case it would go directly to the President) or reject it outright (in which case the bill is defeated and can no longer be considered).

Should the Senate pass an amended version of the House bill, then the bill is returned to the House for a second round of voting. The House can then vote to accept the Senate's changes or reject them. Should the House accept, then the bill goes to the President. If the House reject the changes, however, then the Speaker of the House and the President of the Senate must appoint members to a special Conference Committee tasked with reconciling the disagreements. Once the disagreements are reconciled, the bill goes to both the House and Senate simultaneously and is voted on. If it passes, then it goes to the President. If it fails even one chamber, then the bill is defeated and can no longer be considered.

This brief overview should provide a rough approximation for the process by which tax law is proposed and passed in the United States as laid out in the Constitution. To take the analysis further, we must look to the rules that the House of Representatives and the Senate have passed regarding their own behavior as well.

The Committee on Ways and Means

The Committee on Ways and Means, as it exists today, was first established in 1795.⁶ This Committee is explicitly empowered with the exclusive authority to bring proposed tax laws to the attention of the full House, meaning that all tax policies must originate here. In order to draft tax legislation, the Committee must have some idea that there is a problem in the current tax code that must be remedied. Typically, these problems are identified by the President in his State of the Union address or the Economic Report of the President, though they are also occasionally identified by special interest groups bringing to the Committee's attention.⁷ Once the Committee has a notion of what problems they are attempting to

⁶There was a Committee on Ways and Means established in 1789 but it was quickly disbanded, leaving the Secretary of the Treasury ultimately in charge of proposing fiscal policies, including taxation, to the entire House.

⁷see the vast literature on rent-seeking (Tullock (1967), for example) for a more detailed explanation of why special interest groups would do this

solve, they must then set about finding a solution. To aid them in this process, they hold several meetings. At each of these meetings, several people are afforded the opportunity to speak. The first person to speak at every hearing is the Secretary of the Treasury followed by the Director of the Office of Management and Budget. Several other Administrative members are often invited to speak as are businessmen affected by the proposed legislation. Each person is asked to submit a report and give a testimony based on said report of the impact of changing the tax law on either the Federal government's budget or on the effect that the tax would have on the industry.

Once these meetings are conducted, the Committee retires to its offices in what is called an "executive session." During this time, the proposed bill is marked up for changes in a public meeting, often with staffs from the Treasury and the Joint Committee on Internal Revenue present. Once the markups have been completed, a new version of the proposal is presented to the Committee for approval. A simple majority is sufficient to move the proposal to the final stages, where a final version is drafted along with a report. This draft and its report are then submitted to the full House for approval or rejection. During this time, the House members are not allowed to propose any changes to the bill.

Once the bill passes the House, it is submitted to the Senate Finance Committee, which was originally created in December of 1815 as "The Committee on Finance and an Uniform National Currency" and finally gained jurisdictional authority over all appropriations bills in 1834.⁸

Like the House Ways and Means Committee, this Committee has the exclusive power to bring bills dealing with taxes before the Senate. Put another way, no bill dealing with taxes can be considered by the full Senate unless the Senate Finance Committee has brought it forth.⁹ Once the Senate Finance Committee has been given a bill from the House, it then proceeds to deliberate about the effects of the bill. To aid them in this process, they hold

⁸It was customary to refer all appropriations bills to this Committee regardless, but several times the lack of jurisdiction led to several heated debates on the Senate floor as various members wanted various bills referred to their committee(s) instead of the Finance Committee.

⁹The Senate Finance Committee, however, does not have the authority to refuse to bring a bill before the full Senate. They must present a bill once presented with a tax bill from the House, however even this version presented may be radically different from the House version

hearings that are nearly identical to the Committee on Ways and Means hearings, with the difference being in the version of the bill that is being discussed and (potentially) different members of the Administration and businesspeople. The Secretary of the Treasury is similarly required to be present and granted the right to the first testimony. The Finance Committee collects the written testimonies as well as the verbal testimonies of the panel members and retires to executive session in a similar fashion to the Ways and Means Committee and marks up the bill for any changes. Once the bill has been marked up and the changes (if any) have been incorporated, a new version of the bill is drafted and submitted to the Finance Committee for approval. Again, a simple majority is sufficient to bring the bill to the attention of the full Senate. Once the bill is on the floor, the individual members of the Senate are allowed to propose changes to the bill. Once every Senator has had his say, a simple majority of the Senators present is enough to pass the bill.

A Conference Committee is a joint committee (meaning it consists of members of both the House and the Senate) that is convened only when the House and the Senate approve of different versions of a bill. The Committee is not a standing committee, meaning that membership is limited to the length of time required to accomplish the specific task of reconciling the bill under consideration.

To determine who sits on the Conference Committee, the Speaker of the House appoints conferees from the House (as many as he wishes) and the President of the Senate appoints conferees from the Senate (as many as he wishes). The number of people appointed by each house is irrelevant and can differ, but is usually kept small so as to expedite the process. The Conference Committee then holds as many meetings as are necessary, one of which (usually the first one) must be open to the public. Once a draft of the compromise bill has been completed, each member of the Conference Committee votes on the compromise bill. A majority of the House members of the Committee and a majority of the Senate members of the Committee is required to pass the compromise bill to the full House and the full Senate.

Once the compromise bill reaches the full House and the full Senate, individual members

of each house have the right to object to any changes through a point of order, in which case the rest of the House or Senate can vote to waive the objection. If the objection is sustained, however, the offending lines are stricken from the bill and, if the remainder of the bill passes, it is then sent to the other house for approval.

Once the House of Representatives and the Senate pass identical versions of a bill, the bill is then sent to the President for his final approval. If the President signs the bill, it becomes law. If, instead, the President refuses to sign, the bill is returned to the House and the Senate for one final vote. If the bill receives the support of two-thirds majority of both houses, it becomes law without the President's signature. To aid the President in his decision to support or veto a bill, he is allowed to call his own meetings with whomever he chooses, though typical members include the Secretary of Treasury (again), the Director of the Office of Management and Budget, and economists from the President's Council of Economic Advisors.

3.3.2 The United Kingdom

Unfortunately, written rules governing the behavior of Parliament are few and far between, with most rules being merely *constitutional conventions* that have evolved over the centuries.¹⁰ However, there are a few things that we can say definitively.

All tax bills must originate in the House of Commons per the Parliament Act of 1911.¹¹ Any Member of Parliament (MP) on the House of Commons side may propose a tax bill at any time. Doing so, however, typically takes about a year while the bill is green paper (essentially a draft version) and white paper (final version presented before the house). During the green paper stages, the bill is being drafted under the guidance of anyone that the MP chooses to listen to.¹² Once the MP believes that the bill is ready to be read

¹⁰see Buchanan et al. (1978, pg. 36-41) on this

¹¹There was a second Parliamentary Act of 1949 that pertains to taxation, but it only clarified whether or not the House of Lords had the right to "ping-pong" the bill indefinitely or for a certain amount of time. Ping-ponging is explained below.

¹²there may be rules governing who may write a bill or who may speak at hearings, if hearings happen, but I have come across zero of them in my review of the relevant laws of the U.K. nor have I seen any authors discuss any informal rules of this nature. They may exist, but the literature is ignorant of them if they do.

(typically once it goes to the white paper stage, but occasionally green paper bills are read), there is the First Reading. At this stage, the bill is merely read to the House of Commons and no discussion is had. The bill is printed for every member to read on their own and mark comments on. This First Reading is widely regarded as nothing more than a formality where the main purpose is disseminating the bill and setting a date for the Second Reading.

The Second Reading is a period where the full House meets and debates the general principles of the bill being considered. This stage is largely a discussion about what the bill is attempting to do, what it actually does, and whether or not that is a good idea. After the Second Reading concludes, the bill is then sent to various committees to be debated on line by line, much like the House Ways and Means Committee and the Senate Finance Committee.

A Third Reading happens, where the individual House has a final chance to voice their concerns over the bill being considered. Once the bill passes the House by simple majority, it is sent to the other House which repeats the process of a First through Third Reading. In the case of a tax bill, the House of Commons sends a bill to the House of Lords. The House of Lords then has the authority to amend the bill as they see fit. If there are any amendments, the bill is sent back to the House of Commons which then votes on the amendments made. It is important to note that the House of Lords does not have any authority to defeat any bill, only to prevent it from being passed. Put another way, they can only say that they do not approve of a bill as it is currently written and then send it back to the House of Commons along with their reasons for rejecting the bill. The bill, at this stage, is still not considered defeated. It is merely “held up.” This leads to the notion of “ping-pong,” whereby a bill can, in principle, bounce back and forth between Houses as only the House of Commons can defeat a bill.

Once an identical bill makes it through the Third Reading of both Houses, it is sent to the Monarch for Royal Assent. If the Monarch signs it, the bill becomes law. If she does not, the bill is effectively vetoed. This happens exceptionally rarely and really only

in times where the Parliament attempts to remove power from the Monarch. In all other cases, the Royal Assent stage is considered a formality but in principle any bill may be vetoed. The Monarch typically defers to the judgement of her Cabinet and, especially, her Prime Minister on these matters.

Like the preceding discussion about the U.S. process of taxation, this should provide the reader with a rough overview of how tax policy is passed in the United Kingdom. In order to understand more about this process, however, we need to understand the rules governing the behavior of the committee process involved in the House of Commons and the House of Lords.

Prior to 1967, The Committee of Ways and Means had full authority over all bills pertaining to the budget of the United Kingdom, including all bills having to do with taxation. The Committee was abolished in 1967 and that authority was transferred to the Chancellor of the Exchequer. However, the Chancellor has no authority to actually *change* taxes himself, but can only make recommendations to the House of Commons, typically choosing to do so during the Pre-Budget Report towards the end of the calendar year and at the more formal Budget Report, given in March before the entire House of Commons.

With several hundred members of each House, it became wholly impractical to have the entire House consider each bill line by line. To aid them in this process, the Committee process was established, whereby a committee of anywhere between 16 and 50 MPs would convene to discuss the bill line by line. These Committees are also allowed to bring in any experts that they deem necessary to aid them in understanding the bill and its effects. Unlike the U.S. Committees, there are no rules governing who *must* be in attendance. In this respect, Bertrand de Jouvenal's 1961 essay, *The Chairman's Problem* in which he describes the difficulty of discussing any proposal with a large group, becomes more relevant. As the group size grows, it must either be the case that each person gets less time to speak or the meeting must get longer to accommodate more speakers assuming that everyone gets to speak equally. In either case, the more prudent strategy for the chairman is to select people a certain number of people will speak to the group so that they can 1) complete an

argument and 2) keep the meeting to a reasonable length of time. However, in choosing who gets to speak, the chairman wields an exceptional amount of authority over the direction that the meeting will go.

Membership on these committees is decided by the House speaker and, by convention, the committee members are selected such that there is representation on the Committee by political party proportionate to that of the whole House.¹³ A new committee is appointed for each bill, though the Speaker is supposed to choose people that he thinks are best qualified to discuss the implications of the bill to be considered. Bills having to do with medicine, for example, are supposed to have committees made up of people who were formerly doctors, etc. Simple majority rule is sufficient for passing the committee stage. Once the bill passes the committee stage, it is then ready to go through the First through Third Readings as previously described.

As will be pointed out, it is this difference in the forming of the committees that plays such a crucial role in determining the differences in the outcomes between Congress and Parliament.

3.4 An Example of the Rules Mattering

In 1980, Americans elected Ronald Reagan President of the United States. This came just over a year after the election of Margaret Thatcher to Prime Minister in the United Kingdom.¹⁴ These two national leaders shared a common fundamental belief in free markets, which allows us to analyze more readily the policies that the two countries were attempting to pass and ultimately did pass in light of the rules. To evidence their common goal, we can look at the top personal tax rates of the two countries over the same time period. In 1980 these rates were 73% and 83% in the United States and the United Kingdom respectively which were reduced to 30% and 40% by 1988. Further evidence of this can be found by

¹³Today (post 2005), Committees are selected by the Standing Committee of Selection, which was established under House of Commons Standing Orders 109-111.

¹⁴Technically, it's not really an "election" in the same sense. The Monarch must appoint a Prime Minister who is "most likely to command the confidence of the House of Commons." By convention, this is done by having the party with a majority in the House of Commons elect someone on behalf of the Monarch.

comparing quotes from speeches that the two of them gave. In his first inaugural address, Ronald Reagan said:

In the days ahead, I will propose removing the roadblocks that have slowed our economy and reduced productivity. Steps will be taken aimed at restoring the balance between the various levels of government. Progress may be slow – measured in inches and feet, not miles – but we will progress. It is time to reawaken this industrial giant, to get government back within its means, and to lighten our punitive tax burden.

Later, he reaffirmed his belief when he said in his second inaugural:

We believed then and now there are no limits to growth and human progress when men and women are free to follow their dreams. And we were right to believe that. Tax rates have been reduced, inflation cut dramatically, and more people are employed than ever before in our history.

In a similar vein, Margaret Thatcher also publicly believed in the power of free markets best evidenced in her now-famous “The lady’s not for turning” speech, where in response to rising unemployment following her liberalization policies, she said:

But I prefer to believe that certain lessons have been learnt from experience, that we are coming, slowly, painfully, to an autumn of understanding. And I hope that it will be followed by a winter of common sense. If it is not, we shall not be diverted from our course. To those waiting with bated breath for that favourite media catchphrase, the ‘U-turn’, I have only one thing to say: ‘You turn if you want to. The lady’s not for turning.’ I say that not only to you but to our friends overseas and also to those who are not our friends.

Clearly, both were for reducing taxes for people and restoring a more limited government. However, due to the differing institutional settings that they operated within, their final policies came out differently. This can be shown by contrasting the Economic Recovery Tax

Act of 1981 (which represented a major change in several tax policies) in the United States and a list of tax changes of comparable length passed in the UK between the years 1979 and 1983.

3.4.1 Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981 was a federal law enacted with the express purpose of saving the economy by lowering taxes. The Act would ultimately accomplish this by amending the Internal Revenue Code of 1954 in several ways: first a planned reduction of the marginal income tax rates across the board over the following three year period, cutting estate and business taxes, and finally indexed the tax brackets for inflation where they had previously not been.¹⁵ After much debate in Congress, the Act's sponsors, Jack Kemp (R-NY) and William Roth (R-DE) settled on the bill as it was passed. Thanks to the meticulous records of the Joint Committee on Taxation,¹⁶ we can get a more detailed look at the process by which this bill was passed.

The bill was first proposed at a hearing before the House Committee on Ways and Means Feb. 24-25, March 3-5, 24-27, and 30-31, and April 1-3 and 7, 1981. At these hearings, several people gathered to discuss what Reagan had put forth as the challenge: stimulate an economy by cutting taxes. They then had a markup sessions on June 10, 18, and 22-25, 1981. After being gone over several times, the bill was again brought before the House Committee on Ways and Means where it passed and was ordered reported. After spending the next five days drafting the accompanying report and submitting it to the full House, the full House voted on the bill on July 29, 1981, passing it with a vote of 280-150. The bill was then received by the Senate on July 30, 1981.

Once the Senate received the bill, it was passed to the Senate Finance Committee which passed it immediately to the full Senate on July 31. The Senate made a few changes to the bill, primarily changing the language but also making technical changes in that they

¹⁵Meaning that inflation represented not just a hidden tax in purchasing power but also contributed towards pushing people into higher tax brackets in general.

¹⁶This Committee has no formal role in passing tax laws, merely serving a role in research and archiving the events that transpire, hence its counter-intuitive exclusion from the preceding section's analysis.

changed a few of the proposed tax rate changes. The bill, as amended, passed the Senate by voice vote, at which point the President of the Senate requested a conference with the House of Representatives, appointing Senators Dole (R-KS), Packwood (R-OR), Roth (R-DE), Danforth (R-MO), Long (D-LA), Byrd (D-VA), and Bentsen (D-TX), should they be necessary.

The House, disagreeing with the amendments as proposed by the Senate, agreed to a conference and appointed Congressmen Rostenkowski (D-IL), Gibbons (D-FL), Pickle (D-TX), Rangel (D-NY), Stark (D-CA), Conable (R-NY), Duncan (R-TN), and Archer (R-TX).

The Conference Committee met July 31 and August 1, 1981. There, the group was able to reach a compromise position that quickly passed the majority of the Conference Committee, which sent the bill to both the House and the Senate for consideration. The Senate passed the Conference version of the bill on August 3rd with a vote of 67-8 and also passed a directive to the Clerk of the House to “make certain technical corrections to the bill.” The House agreed with the Conference version on August 4th with a vote of 282-95 and also agreed to the technical corrections suggested by the Senate. With that, an identical bill had been passed by both Houses and was signed into law by President Reagan on August 13, 1981.

In full disclosure, the very notion of summarizing all of the effects of the Economic Recovery Tax Act of 1981 here is laughable as the report itself (which is meant to summarize the effects of the bill so as to more easily allow politicians and judges to understand the changes being enacted) is 424 pages long, with the Table of Contents alone taking 10 pages. That said, the goal here is to demonstrate that the Economic Recovery Tax Act of 1981 represented a sweeping change in legislation. What’s more, Reagan was able to accomplish these sweeping reforms despite only having a slight Republican advantage in the Senate (53 Republicans - 47 Democrats) and a disadvantage in the House of Representatives (244 Democrats - 191 Republicans).

The Economic Recovery Tax Act lowered taxes on income for every person regardless

of what income bracket they were in. It also provided business incentives that allowed businesses to record the depreciation of their assets over a longer time period, allowing them greater deductions and greater access to investment tax credits provided that they could demonstrate reinvesting in the aforementioned capital. It overhauled the banking sector, reducing the tax penalty of converting mutual savings funds to baskets of stocks and vice versa. It also exempted interest earned on government savings bonds that met certain criteria and a partial exemption to earnings from stock dividends and interest income. It overhauled the tax code on windfall profits during a time where oil was being discovered all over the United States, lowering taxes on newly discovered oil fields.

Again, this is not meant to provide an exhaustive list of the reforms accomplished in this bill nor is it meant to detail the exact specifications of the provisions of the bill. Rather, it is meant to show that the reforms were wide-reaching and indeed, they were.

3.4.2 Bills Passed by the Thatcher Parliament

Turning to the U.K., we can consider a series of bills passed through Parliament starting in 1979 when Thatcher first took office and ending in 1983. The bills identified here represent all tax bills that were passed in the U.K. during this time period.¹⁷ What will be shown is that it took Thatcher considerably longer to pass considerably less reform to the tax system than it did Reagan. What's more, she did this despite a greater majority in the House of Commons (the Conservative party had 339 seats out of 635 seats; the closest political competing party, the Labour party, had only 269 seats). Unfortunately, Parliament does not keep as meticulous of records as Congress does (or perhaps they are not publicly available), and so little discussion about the actual process by which the bills were passed can be had. However, there are several things that we can deduce from available records that will show the effect of the differing institutional arrangements on proposed tax legislation.

On March 22nd, 1979 Parliament passed the Capital Gains Tax Act of 1979. The Act essentially describes under what conditions a person must pay upon the sale of things such

¹⁷there were other discussions of tax policy throughout this time period, however they were little more than technical amendments to the bills listed here

as stocks, bonds, and other assorted properties. It specifies what the tax rates will be to various people who meet differing criteria (single people, single earner married couples, double earning married couples, and all three of these under various specifications of income levels). It specifies conditions under which taxes apply and do not apply to conversions of securities and the sale of property and finally disallowed considering insurance premiums as business expenses.

On January 31, 1980, Parliament passed the Petroleum Revenue Tax Act of 1980. At six pages, this Act is designed to clarify when tax payments on oil pumped from previously known oil reserves and as such is best considered a clarification/amendment to a 1975 bill regarding the taxation of profits from oil. The essence of this bill is that the tax paid by an oil proprietor is due prior to the actual pumping of the oil. The proprietor is required now to estimate how much oil he will pump from the ground and then a formula for calculating an expected price of oil is applied to figure out how much tax revenue is actually owed. At the end of the taxable period, the actual results are compared to the previously anticipated results and debts are settled from there – in the event that the person overpaid his taxes, the Government will reimburse him the difference, for example. Effectively, this tax policy acted not to reduce tax rates, but to raise them, since oil producers were being now being robbed of the interest on their profits.

The Car Tax Act of 1983 was passed on July 26, 1983 and added a tax to owning a car, regardless of whether it was made in the U.K. or not. There were several considerations that went into whether or not a car was taxable, but it can be summarized as “if it looks like a passenger car, it gets taxed.” This applied even to cars that were not in working order, with the bill saying “for the purposes of the tax, a vehicle which is not finished and complete but which, if finished and complete, would be a chargeable vehicle shall be treated as a chargeable vehicle.” Exemptions were made for any vehicle which was not designed to carry passengers, ambulances, prison vans, and vehicles more than 20 years old. The remaining 12 pages of the bill are, essentially, conditions under which people may sell or otherwise dispose of the car and what the tax payments would be under each situation.

On December 1, 1983, Parliament passed the Oil Taxation Act of 1983. This Act, like the Petroleum Revenue Act of 1980, was designed primarily to amend the Oil Taxation Act of 1975 but it also clarified the relationship between the existing tax laws on oil and the Continental Shelf Act of 1964, which regulated business activity on offshore oil exploration efforts. It closed several loopholes in the existing oil tax legislature, specifically when something became a non-mobile asset towards pumping oil. To avoid taxes, oil companies had been “temporarily” docking floating platforms to existing oil rigs (which themselves were not permanently attached to the ground but had massive underwater frames and anchors that kept them effectively still) and claiming them as mobile assets, which were taxed at a different, and much lower, rate. This Act closed that loophole, saying that the asset becomes “dedicated to a particular oil field” if it’s used for a sufficient amount of time during the taxable period at one *or two* oil fields.

Finally, on July 26, 1983, Parliament passed the Value Added Tax Act of 1983. This Act was designed to “consolidate the enactments related to value added tax.” Here, Parliament raised taxes on the sale of intermediate goods, with the tax being due at the time of the sale. The Act also clarifies several cases where various acts over the years had contradicted themselves, explaining which ruling applied in which case as well as expanding the scope of what was considered an intermediate good. There are also several noteworthy exemptions. Land, insurance payments, payments to the government post office (though not private delivery companies nor on the value of using your own trucks to deliver intermediate goods), gambling, finance, education (though in certain cases, textbooks and other classroom materials would be taxed under the VAT), health care, burials, sporting contests (again, only under certain conditions), and works of art were all exempt from the VAT.

3.5 Evidence of the Rules Affecting the Outcome

While all of this is certainly indicative of *what* happened, there is no discussion here of *why* it happened or how it differed from what Thatcher would have wanted to have happen. One

way to evidence that Thatcher accomplished less in the way of lowering taxes and that the Parliamentary system played a role in determining what the final tax policies looked like is to compare the number of pages the bills took with the number of pages in their Tables of Contents and the length of time taken to pass the bills.

On Reagan's side, his Economic Recovery Tax Act of 1981 weighed in at 185 pages and was passed in just 170 days, from the time of its initial presentation before the House Ways and Means Committee to Reagan's actual signing. Thatcher's tax reforms, however, required 342 pages and took 1,544 days to fully enact.

As can be plainly seen, the Economic Recovery Tax Act of 1981 was significantly shorter and was passed much more quickly than the tax reforms passed under Thatcher. One explanation of this comes from observing the differences in the rules of the forming of committees. To reiterate, in the U.S. Congress, these Committees are established *ex ante* and are generally long-standing. In Parliament, however, the committees are formed once Parliament has decided that they want to consider a bill that would affect some industry. The committee members are then selected based on their expertise. One explanation for longer, more complicated tax codes in The United Kingdom is that, while it may be beneficial to have experts in a particular area helping to create the legislation governing this area, this is also not without costs. Namely, these legislators are in a perfect position to provide favors to former coworkers, friends, etc. Direct evidence of this is difficult to come by. However, several scholars have been able to find indirect evidence of exactly this happening in various contexts throughout history.

Politicians each possess a vote in their respective governing body, with these votes determining whether or not a policy gets passed. For the average citizen, any given bill will either cost them a few pennies or grant them a few pennies worth of annual revenue. Large, well-organized special interest groups, on the other hand, stand to gain millions of dollars in special benefits with the passage of certain legislation.¹⁸ These groups have every incentive to lobby government officials in an attempt to capture these rents, as Tullock

¹⁸See Addison and Hirsch (1989), Cowen (2002), Coyne and Leeson (2004), Hirsch (2007), and Hirsch (2008) for examples of special interest groups gaining political favor

(1967) described them, as the cost of the bill will be spread across all of society while the benefits will be concentrated on them. Further, since no individual non-politician's vote is likely to affect the outcome of an election, voters are likely rational to not acquire the necessary information to vote in such a way as to prevent the passage of a bill that actually harms them. This is, as Caplan (2007) describes, rational ignorance, where the cost of acquiring the information exceeds the benefit of that information. What this means is that politicians are able to sell their votes to the highest bidder.¹⁹

Selling their votes to the highest bidder among special-interest groups is not the only way that politicians are able to sell their votes. They are also able to sell their votes to one another in exchange for later votes in a process referred to as log-rolling. Ordinary citizens are unable to do this because when we vote for something it is always done behind a curtain away from prying eyes. This is done so that nothing can influence voting behavior. However, a side effect of this is that any attempt to buy a vote is fundamentally unenforceable as there is no way for the principle to monitor the agent.

Politicians, on the other hand, vote in the open. This has the advantage of allowing their constituents to observe their voting records to monitor their performance once they have been elected. However, this has the side effect of allowing them to monitor each other. This enables them to credibly commit to honoring their deals as cheaters who defect on their previous agreements will damage their reputation and be unable to make subsequent deals.

Anecdotal evidence of rent-seeking and logrolling mattering for policies dates back to 1907²⁰ but more recently, Stratmann (1992) finds very strong evidence that “legislators trade votes and that legislators with strong preferences are most likely to trade votes” by looking at the voting records of Federal Congressmen in the U.S. during the Reagan administration. Kroszner and Stratmann (1998) suggests that politicians form long-standing committees because of an inability of special-interest groups to enforce fee-for-service arrangements

¹⁹Obviously there are some constraints on this ability. See, for example, Besley and Burgess (2002), Djankov et al. (2003), Leeson and Coyne (2005), Besley and Prat (2006), and Coyne and Leeson (2009). Most of these can be thought of as reductions in the cost of acquiring information about proposed legislation.

²⁰see Bentley (1907), especially pages 200-222, but also 447-460.

with politicians. The committees, however, allow them to do so by encouraging repeated play. The result, the authors find, is a stable equilibrium of high contributions on the part of special-interest groups and high effort on the part of politicians. Faccio (2000), looking at 20,202 publicly firms across 47 countries, finds that political connections are strongest where the regulations against forming them are weakest and that they add “a significant increase in corporate value.”

The question then becomes one of whether or not rent-seeking and logrolling actually changes policies by changing the votes of politicians or if it merely funds the provision of policies. To answer this question, we can again turn to the existing literature. Stratmann (1992) tested whether or not logrolling occurred on various votes of the 1985 Farm Bill in the U.S. House of Representatives and found that congressmen from districts that farmed peanuts, dairy, or sugar traded votes to get all three provisions passed. Stratmann (1995) finds evidence that not only is logrolling widespread, but that many party members actually changed their votes because of previous agreements with other politicians and that political parties serve as a means to coordinate the exchange of votes. This is also very stable over time. Voting against the party, therefore, is exceedingly rare. Finally, Elvik (1995) provides evidence that this is not a uniquely American phenomenon, describing how logrolling explains the distribution of highway expenditures across Norway.

While empirical evidence of logrolling and its effect on Parliament is difficult to come by, Buchanan and Tullock (1962, pg. 130) provides one possible explanation as to why this is the case. Here, the authors discuss “implicit logrolling” of the type that is wholly unobservable to the outside world as it takes place within the political process. For example, a proposed bill for funding education in a particular area is almost guaranteed to receive the support of the politician representing that area regardless of what else is in that bill. It should come as no surprise that education bills, therefore, typically come packaged with additional proposals (Margolis, 1961).

3.6 Conclusion

To conclude, this paper does not intend to be a be-all-end-all discussion of why tax policies differ across countries. There are certainly a variety of factors that may contribute to this – e.g. wars, the ability to print money, famines, natural disasters, etc – each of which likely play a nontrivial role in shaping the rules adopted by the fiscal institutions of a government. And in fact, the very example that this paper offers as evidence that the rules matter may have been driven by one of these other factors; namely, the assassination attempt on President Reagan on March 30, 1981. After his recovery, it is at least plausible that the President enjoyed a massive surge in approval, perhaps as a result of sympathetic voters. Why this would influence the preferences of voters is beyond the scope of this paper, but it may nonetheless be plausible. However, economics is not just about the behavior of individuals; it is also about the institutions within which that behavior occurs. In this regard, this paper contributes towards our understanding of why different nations pass different tax policies when they pass them.

Taking for granted the claims made by the fiscal philosophers about what an ideal tax policy ought to look like, we must then consider the fact that tax policy is ultimately passed by fiscal realists – people who have to actually write legislation and get it passed through the legislative body. In this sense, the rules that they face very much matter as they shape the options and strategies that they are able to employ in order to accomplish their goals.

We see this evidenced in the historical records of the passages of the Economic Recovery Tax Act of 1981 in the United States and the various tax policies passed by the Thatcher Parliament from 1979-1983. Because of the differences in the structure of the rules governing tax policies, each subitem in the overall Thatcher plan was implemented one at a time as compared to the sweeping legislation that Reagan was able to pass through Congress. The greater amount of voting that took place within Parliament allowed for more implicit political bargaining and thus fundamentally changed the final outcome.

Tax policy is not something that is merely created in a vacuum by some overarching entity known as “government.” Rather, it is the result of a series of exchanges within an

institution, albeit a different institution than a marketplace, that produces a final product that no one person ever truly designed. In this sense, creating a tax policy is, at least at a fundamental level, like the creation of a pencil in that no one person created any given tax legislature on his/her own. A pencil, as Read (1996) describes, is not made by any one person but is instead the product of millions of people around the world working together despite no one of those people having the requisite knowledge to produce a simple pencil by themselves. A pencil is therefore produced as these people each add their own highly specialized knowledge towards the creation of a pencil. In much the same way, no one politician could write a tax code. Instead, each contributes but a small amount of knowledge towards the final product. In order to continue studying the creation of policy in general, comparative public policy scholars must acknowledge the existence of this quasi-market that politicians operate within. This includes an analysis not only of the voting rules governing the behavior of the politicians themselves, but also an analysis of the rules of who is allowed to speak and when. Second, comparative public policy scholars must recognize that policies in general are an emergent phenomenon rather than a directed phenomenon. They are the result of the complex interaction of several politicians seeking their own goals using the means afforded them by the rules by which they are governed.

Chapter 4: Micro-Level Catallactic Public Finance

4.1 Introduction

De Viti De Marco (1936) provides an early analysis of the field of Public Finance, recognizing the difference between “Private Economics,” which is the realm of market activity, and “Public Economics,” which is the realm of State expenditures on public goods. Despite the difference in name, De Viti notes that this difference does not call for a radically different approach in the economic analysis between these two distinct Economics. Buchanan (1949) and Hebert and Wagner (2014) describe that there are two “analytical windows” through which public finance can be viewed. On the one hand, the behavior of governments can be viewed in a single, representative agent model whereby some agent is choosing the outcome that society receives. This chooser can be discovered in a variety of ways, but the point is that someone or some thing deliberately chooses among relevant alternatives in an attempt to maximize some objective utility function. This view comes with it the benefit of analytic tractability in the sense that one can model the outcomes of politics and analyze them against a notion of optimality. However, this view also comes with costs, namely a difficulty in explaining observed political outcomes. For example, forty-nine states have in their constitutions a balanced budget requirement. The US Congress has similarly imposed balanced budget requirements on itself at times. Given this, it should be surprising that within a choice theoretic framework as laid out in this view that state and federal budgets are characterized by nearly universal deficits. So, while tractability may be a feature of choice-theoretic models of public finance, there is divergence between the logic of the models and the observed outcomes.¹

¹To be sure, there is also some degree of congruence. See Mankiw et al. (2009).

Alternatively, the behavior of government can be explained as a series of interactions among various politicians operating within a framework of rules, each of which contributes but limited knowledge towards the final outcome in a quasi-market type arrangement. This final outcome, therefore, is not the result of any one agent's decision calculus, but rather emerges as an end result of a political process that governs the interactions among the politicians. This approach comes with the benefit of realism, whereby the observed world is one where politicians do possess limited knowledge and are operating within a framework of rules. However, pursuing this approach loses the tractability of choice-theoretic models, instead relying on an examination of the rules at play. In giving up this analytic tractability, however, a greater degree of understanding the source of political outcomes can be achieved without making reference to any sort of a normative standard.

Buchanan (1949) explains these differences as being between an organismic theory of the state, where "the state and all individuals within it is conceived as a single organic entity." Here, the actions of the state are conceived as being the choice of one representative agent which maximizes a standard optimal choice problem between providing public goods and providing private goods. Analysis of this type is similar to the analysis put forth in Stratmann and Baur (2002) and Bawn and Thies (2003), which analyzes the differing incentives faced by politicians under different types of political representation schemes. Here, the authors analyze which point is chosen by an agent denoted as Government among relevant alternatives and compare these points to the optimal point.

By contrast, Buchanan (1949) explains the individualistic state as one in which the state is "represented as the sum of its individual members acting in a collective capacity." Here, there is no representative agent maximizing some standard choice problem familiar to students of economics; instead, there is a group of people interacting with one another within a framework of rules that then produces a collective outcome. The key difference between these two positions, though, is that in this framework there is no selection of a single point in X - Y space, but rather the point emerges out of the interaction of these various individuals.

Hebert and Wagner (2014) explains these as a difference between “fiscal philosophers” and “fiscal realists.” Fiscal philosophers are scholars who start with some normative judgement of what a tax code ought to accomplish and derive optimality conditions from there. These normative judgements can be any sort of arrangement, from equalizing income net of taxes across individuals to nudging peoples behavior in a certain direction, which may entail some degree of congruence to prevailing accepted beliefs of society, but they are normative all the same. As Buchanan (1967, pg. 228) says, “taxation can be fruitfully discussed in such terms. Nevertheless, it is also true that, to the extent that value judgments enter the discussion, genuine scientific analysis comes to an end.”² Fiscal realists, on the other hand, are people who ultimately pass tax policies by contributing limited bits of knowledge towards the final output and are operating within a framework of rules in order to accomplish this goal. In this way, Hebert and Wagner (2014) views tax policies as being created within a sort of quasi-market process, with individuals interacting with one another to produce a final outcome known as a tax bill.

This paper further pursues the notions of the individualistic state and the fiscal realists presented in these papers, calling the synthesis of these ideas “catallactic public finance.” Catallactic public finance, as will be discussed, puts a greater emphasis on the idea that only individuals can choose (Buchanan, 1969; von Mises, 1998a) and that groups therefore cannot make decisions absent a framework of rules. To illustrate this, imagine putting 500 people in a single hotel conference room and telling them that they have to make a decision about what the entire group will have for dinner. Undoubtedly, various factions will arise arguing for the superiority of one dish over another. However, in order to effectively make a decision, this group will have to decide on some rules by which their individual wants will be transformed into collective wants. These rules are not a feature of the world but must somehow be decided upon with the recognition that different systems of rules may produce radically different results.

²He is quick to qualify this, saying “This is not, of course, to suggest that normative discussions cannot be helpful. I suggest only that such discussion can best be postponed until analysis on a pre-value basis is fully exhausted.”

While this paper does not reject out of hand notions of general welfare or social utility as having a degree of explanatory power, it does suggest instead that what is of primary importance (and what should therefore receive further treatment) is the pattern of interaction of the various politicians involved in the actual creation of the tax bill. While it is certainly true that the nature of the position that politicians occupy does entail some degree of deference to their constituents (i.e, they are highly unlikely to support a measure that their constituents unanimously and vociferously oppose), there also remains great scope for divergence from their wishes.

This paper will proceed as follows. In the next section, I briefly outline two current approaches to understanding tax policy and the provision of public goods, which are denoted as the closed system and open system approaches. The closed system approach is one by which the economy is a technical problem that can in principle be solved if only the correct rules are in place at both the constitutional and post-constitutional levels, where the ultimate question to the economist is one of resource allocation. The open system approach is one that places greater emphasis on the process by which outcomes come into existence, placing the economist as a student of exchanges and the institutions within which those exchanges take place. Section three sketches forth a theory of catallactic public finance, contrasted with a more standard approach to analyzing public finance. Section four provides an illustration of this by way of describing the various committees involved in passing a tax legislation. Section five concludes and discusses avenues for further research.

4.2 From Social Welfare Functions to Political Processes

4.2.1 The Closed System Approach

Samuelson (1955) describes the objective of governments as being one of finding the social utility-maximizing combination of public and private goods. Placing these goods along the axes, identifying a production possibilities frontier, and applying a well-defined social utility function gives rise to a familiar Lagrangian maximization problem whereby an optimal point

can be selected. Samuelson (1955, Figure 1), reproduced below, provides an illustration of this:

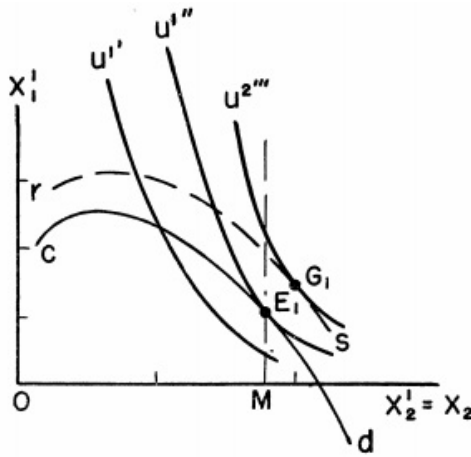


Figure 4.1: Samuelson's 1955 Illustration

In this view, the subject of economics is one of resource allocation and, by design, there must be a unique allocation of resources that is optimal - it simply cannot be any other way. By way of analogy, to say that there was no optimal resource allocation would be similar to saying that there was no highest point on a mountain. The role of the economist within society, therefore, is one of "savior," to use the language of Coyne and Boettke (2006). Here, the economist not only has special knowledge and training but is able to apply that knowledge and training in ways that improve upon a given situation much like a Sherpa has special knowledge and training to guide people up a mountain safely. To put it simply, the market alone (like our wary travelers seeking to climb the mountain) can only get society to a corner solution in the above axes. This solution is known to fail to maximize social utility, as private goods and public goods are both considered to be economic goods and preferences for private goods are not considered to be lexicographic. What is necessary, therefore, is a means to get society from the trappings of the corner solution and to the optimal allocation between private and public goods. This will mean that society will have to trade some of the production of private goods in order to increase the production of public goods, to be sure, but the sacrifice from a reduction in the output of private goods will be small relative

to the benefits of increased production of public goods. This then brings us to a discussion of how those public goods are provided.

Economists have long recognized there is not one single person who chooses an outcome in politics. Rather, this decision comes about as a result of some process of collective decision making. In most democratic settings, this process is one of majority rule. It need not be, but most political decisions are made in this way. In these settings, it is therefore the median voter who gets what he wants. Suppose, for simplicity, that Jim, Bill, and Steven are considering a proposal and that they vote by dropping a ballot in a ballot box which is then tallied. Jim and Bill each vote for the proposal and Steven votes against it. Predictably, Jim and Bill are going to get what they want, but which one of them was the median voter? This question, as it is posed, cannot be answered because there is no way to answer it. We could answer this question if it were the case that these three voted sequentially, such as if Bill voted followed by Steven followed by Jim, but this is not how most democratic processes work. However, economists and social scientists proceed *as if* this median voter was, in fact, a real person and then analyze its decisions against what was optimal, with any divergence from optimality necessarily being suboptimal.

The question then becomes one of why a suboptimal point was chosen when the optimal point was attainable, shifting the discussion to one of the rules by which the voter's wants are communicated or miscommunicated.³

When it comes to discovering these wants, several scholars have put forth various means of doing so as a response to the declaration in Samuelson (1954) that revealing demand for pure public goods was impossible.⁴ Hylland and Zuckhauser (1970) proposed a stylized version of a Borda count that would induce voters to allocate their voting points among competing issues as a means of determining intensities of preferences. Clarke (1971) and Groves (1973) proposed charging voters a special "incentive tax" equal to the costs of their

³Interestingly, operating within this framework of understanding the world should call into question the optimality of that predetermined point as compared with the point that is selected, as Stigler (1992) points out. Curiously, it doesn't.

⁴The following is meant to provide a mere summary of the history of demand-revelation mechanisms. A more complete discussion of this can be found in Mueller (2008)

participation in the group decision-making process imposed on other voters. Mueller (1978, 1984) described a three step process in which everyone first proposes a quantity of public goods desired and a tax formula to pay for it followed by a randomly selected order of veto voting over each proposal will induce a person to reveal their true demand for pure public goods in much the same way that a second-price auction induces people to reveal their true valuation for a private good in a sealed bid auction. The point here is that, absent a means to induce people to truthfully reveal their preferences for public goods, a suboptimal point may be selected.

On a theoretical level it is of course possible to design systems that reveal demand and therefore a social welfare function, this result should not be surprising. It is no wonder that, when assuming a god's-eye-view of an economy which gives access to every individuals' utility function ex ante, a social welfare function can be constructed and various means of revealing this social welfare function can be contrived and checked against the contrived reality. In the real world, however there remains several problems with this approach, chief among them being the lack of access to this god's-eye-view as Hayek (1937, 1945) describe. In addition, there is also the problem of policy design and policy implementation, each of which will take time and, by the time that this process is completed, the optimal demand revelation mechanism may have changed. Without the god's-eye-view with which to check the results against, the social welfare function, insofar as it exists, becomes impossible to determine and check against. There is, as Wicksell (1958) observed, no one person in charge of making these decisions; instead, they emerge out of a process of political interaction that resembles a market process, as explained by Wagner (1988). This is true even if we explicitly charge a specific committee with creating a tax code, for there are no committees of but one member.

There is a second source of suboptimal behavior on the part of the median voter. Economists have recognized that politicians could be induced to vote for suboptimal outcomes in a representative democracy based on the rules by which they are elected. Strattmann and Baur (2002) provides one example by looking at different means of electing (and

reelecting) politicians on pork-barrel spending in Germany. The authors find that, in a system characterized by first-past-the-post elections, the politician faces a stronger incentive to provide “geographically based benefits” to their constituents than politicians elected in a proportional representation system. To be sure, there is a strong incentive to engage in pork-barrel spending under both systems, however the authors were able to demonstrate that the incentive is in fact much stronger under first-past-the-post systems. The authors conclude their paper by noting that “electoral rules have a significant influence on day-to-day legislative behavior, which in turn affects government policy.”

Bawn and Thies (2003) provides another example of this by comparing the degree to which unorganized groups are represented under single member districts, where voters elect a single person to represent them in a legislative body, and proportional representation, where voters vote for a party and the composition of the seats in the legislative body are then allocated according to the proportion of votes that each party receives. The authors find that the answer to which system best represents the unorganized is context specific and depends on factors such as how influential the party is to the reelection efforts of the individual politician. Again, the rules have an impact on the behavior of the politician once elected which in turn influences policy.

While both of these works recognize the importance of rules in determining outcomes, applying this insight to the optimal public goods literature would suggest that these rules either enable the optimal point to be selected or act as a hindrance toward this result. The solution, therefore, is to codify the correct rules that will provide politicians with an incentive to enact the optimal policy, whatever that may be. By way of illustration, consider a figure that Wagner (2012) provides (reproduced here):

While Wagner does not say this, suppose that point Z has been determined to be socially optimal and that everyone knows and agrees that it is socially optimal. There are other combinations that are privately optimal (for example, Prima would like less X and more Y than what would be offered at point Z), but point Z has nonetheless been determined to be socially optimal. As Wagner does point out, whether the voters choose point Z is

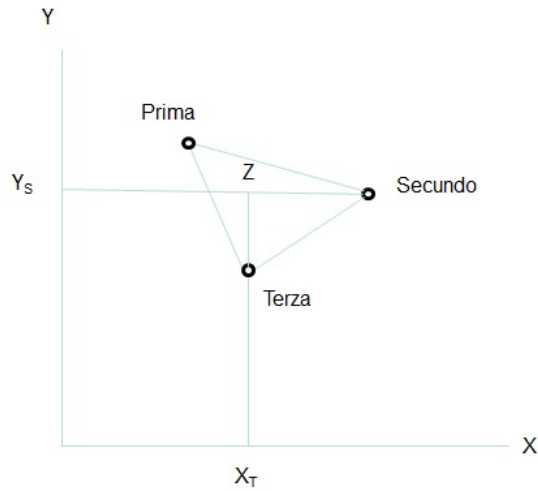


Figure 4.2: Rules and Collective Outcomes

a function of the voting rules that these individuals face. If they were to vote under a majority rule on X and Y separately, Z would emerge. However, if they were to vote on X and Y together, there is no guarantee that Z would emerge and the likely result would be an outcome along the contract curves connecting the pairs of voters and would depend on which coalition between the voters emerged. Still further, if any one of these people were to be given dictatorial power, point Z would almost certainly not be selected in favor of whichever point the dictator prefers. Of these three options for determining collective outcomes, voting on X and Y separately would be deemed the optimal set of rules as it brings about the optimal allocation of goods, point Z , and it would be the job of the economist to bring about these rules.

Considering yet a third possible point of departure from the optimal policy outcome is the role of the chairman of a committee. To illustrate this, we can turn to a familiar illustration popularized in Appendix A of Buchanan and Tullock (1962), where a small committee made up of politicians 1, 2, and 3 each rank policies A , B , and C in order of preference and subsequently vote on the issues two at a time.

The chairman of this small committee wields decision-making power by virtue of his ability to set the agenda for the vote. For example, should politician 1 be the chairman of this committee, he will set the vote to be against B and C first, eliminating C , before

	1	2	3
Best	A	B	C
Middle	B	C	A
Worst	C	A	B

Figure 4.3: Voter Preferences

voting between A and B , which would produce outcome A . If policy B or C were determined to be the optimal policy from a social perspective, a suboptimal outcome would be the result merely due to the selection of the wrong committee chairman. For example, Debbie Stabenow (D-MI) is currently the Chairwoman of the Senate Committee on Agriculture, Nutrition, and Forestry. It is little wonder that farm bills, which are typically passed every five years, have included a provision that sugar beets be specifically included under the federal sugar subsidies when one considers that sugar beets are a major business for a significant part of the Michigan population. This is not to say that sugar beet subsidies are suboptimal, rather it illustrates a source of the belief that the individual politicians matter. Thus, if a suboptimal social outcome is the result of a process that resembles the above, the popular notion of needing to get the “right people” elected and put into the “right positions” gains intellectual merit.

Therefore, policy analysis within this type of closed-system framework is essentially a three step process with most papers focusing on one of these three steps. First, the optimal point must be determined. There are difficulties with accomplishing this step, owing to the fact that every individual constituent has an incentive to misreveal their preferences in the face of concentrated benefits and dispersed costs. Second is getting the optimal (re)election rules enacted. Again, there are difficulties with doing this as it would require that we predict the (potentially) opportunistic behavior of politicians *ex ante*. Third is getting the right people elected into the right positions. Again, this may prove difficult given the nature of politics and politicking.

Given the assumptions of economics, the only culprit that could explain this divergence is the rules that different individuals face in their roles in the political process. These rules, therefore, need to be changed in order to bring about the optimal policy outcome. In the

case of the constituent, society simply needs to adopt rules that induce revelation of true preferences for public goods and incentivize the election of the correct candidate. In the case of enacting this policy, society simply needs rules that align the incentives of the politicians with those of society as a whole. The rules, therefore, either enable the optimal policy outcome to exist or are a hindrance and it is the job of the economist and social scientist to design a system that successfully brings about the optimal policy.

4.2.2 An Open System Approach

Note the implicit and sharp dichotomy between goods provided privately and goods provided publicly. Private goods are understood to be the product of an invisible hand (Smith, 1776) that guides the entrepreneurial efforts of various individuals (Hayek, 1937) and drives continued innovation through competition in a market setting (Kirzner, 1973, 1997). These models are, to a great extent, considered to be open ended in that, while there is coordination, there is not a single *coordinator* who has pre-determined each participant's actions leaving room for exogenous shocks that can be absorbed into an error term. By way of illustration, consider the lessons found in Read (1996). Here, there is no person in charge of producing a single pencil and yet the entire process is completed from start to finish with such regularity that this process can largely be taken for granted today.

Within markets, the idea is that man is not behaving according to a “smooth, continuous, and twice differentiable utility function,” but his behavior is instead rendered intelligible through understanding that man experiences felt uneasiness in the given state of the world and acts to remove that felt uneasiness to the best of his ability. What guides his actions is not an equation, but rather his subjective hopes, dreams, and valuations and the objective array of prices that he faces. To collapse all of that into an equation is to remove the human element from the very subject that economists study, which is a curious endeavor given that economists study the action of real human beings in the real world. Modeling man's behavior amongst men as if it were organized by some planner may sound attractive and lends analytic tractability, but, as Wagner (2007b) puts it, doing so “is to parade ignorance

as knowledge” as the process in fact has none of the features of pre-determination.⁵

It is here that Buchanan (1979) provides the most cogent explanation of what economists ought to do by describing how economics is centrally a science of exchange or contract and “that this paradigm should take precedence over the maximizing paradigm” that is central to the closed system approach. He goes on to say further that “the essential subject matter for the economists consists of human behavior in social institutions, not of human behavior in the abstract” and that economists must “concentrate their attention on a particular form of human activity and upon the various institutional arrangements that arise as a result of this form of activity.” Marciano (2007) describes Buchanan’s position more succinctly by stating that “he links the ‘propensity to truck, barter, and exchange’ to the institutional setting within which individuals barter and exchange.”

Within this exchange framework, the economist ceases the attempt to solve the allocation problem and instead focuses on the process by which exchange happens and the institutions within which that exchange takes place. To be sure, exchange and the institutional arrangement within which those exchanges take place does impact the allocation of resources, but this end result is not what the exchange-focused economist is studying. Wagner (2007b) provides an excellent illustration of this by way of discussing the analysis in Demsetz (1967): at one point in time, there were no property rights governing the harvesting of furs in Labrador and then, as a response to an exogenous technological change, there suddenly were. The article discusses the impetus behind the generation of property rights but does not discuss the source of that impetus or the process by which those property rights were developed.

What if we instead thought about the provision of public goods within a similar (though not fully identical) framework as private goods? Put another way, what would public finance look like if we were to, as De Viti De Marco (1936, pg. 57) says, “break down the State’s calculation into the economic calculations of the individuals or the groups which represent the constituent elements of the State’s calculation?” It would be necessary to discuss the

⁵This methodological point has been discussed elsewhere. See, for examples, Buchanan (1964, 1969) and Wagner (2010)

process by which the decisions governing the provision of public goods are made. As Wagner (2007b) details, there would be an “active voice” that describes who did what. This active voice would not only describe the behavior of people within the rules that they are given, but must also describe the selection of the rules themselves. To illustrate this, consider the difference between buying and selling goods in private versus public settings.

Buchanan (1967), aptly titled “Public Finance in Democratic Process,” provides a useful starting point for this analysis where he makes the observation that the provision of public good is fundamentally the result of two separate steps. In one of these steps, Congress must decide what they want to spend money on. In a similar fashion, they must decide how to raise that money. While related to one another, these decisions are made separately by different committees made up of different people and at different times. Conventional wisdom, where Ricardian equivalence holds true, would suggest that the order of these decisions matters. For example, if an appropriations bill is passed before a tax/revenue generating bill, this would, it is thought, force the hands of the tax/revenue committee members to act in a certain way so as to raise a sufficient amount of revenue to cover the spending decisions that have been made. By similar logic, passing the tax/revenue generating bill first ought to constrain the spending habits of those in charge of the appropriations bill.

However, as Wagner (1992) and Yoon (2000) describe, this is only true if there is a notion of residual claimancy. In the world of politics, however, such a residual claimant is purely imagined and entirely nonexistent as the property rights structure is collective rather than private. In other words, Ricardian equivalence might hold true, but if it does it is merely by happenstance and not by institutional design. Treating it as if it were a fact of the world would therefore be false.

To illustrate this, Buchanan (1967, pg. 87) discusses the difference between the decisions that individuals make in a market context and the decisions made by those same individuals in a political setting by noting that the decision to acquire and spend is made simultaneously in the former and separately in the latter. He quips, “it is absurd to think of [individuals in a market context] making two separate decisions, one as to the physical quantity of the

good to be purchased and the other as to the total outlay to be made. Given the availability of a good or service at an invariant market price, these two decisions reduce to one and the same.” In market purchases, we can decide how much of a good we wish to purchase, which then determines how much we will have to spend. Alternatively, we can decide how much we want to spend on the good which then determines how much of the good we will receive. Uncertainty about the price changes nothing about this, only changing a definite cost or quantity received to a range of cost or quantity.

Contrast this with the process by which a good is provided by government. Here, the decisions are made separately. Thus, it is the rules that transform the preferences of the individual group members into a collective decision. Again, what is key is the recognition that no one person (even the Chairmen of the Ways and Means Committee and the Senate Finance Committee) has the power to simply enact an entire tax policy on their own but must instead garner sufficient support. That support can come in a variety of ways, including (but not limited to) exemptions from certain types of taxation or direct transfer of wealth to a particular district, which can be viewed as a sort of “compromise.” What is therefore necessary is a discussion of how these decisions are made. This does not necessitate jettisoning all that economics has brought to bear on the issue of public finance. Rather, it calls for a refocus of the field from optimizing collective outcomes to explaining the emergence of social outcomes through a process of exchanges that take place within parliamentary assemblies.

4.3 Catallactic Public Finance

“Catallaxy” is a term that describes the emergence of social outcomes as a result of the purposive action of individuals interacting with one another, which is encapsulated in Hayek’s discussion of a spontaneous order. These interactions are in turn governed by rules in such a way that there is no one person directing every other person. Wagner (2007a, 2010, 2012) describes this distinction by comparing the actions of individual people marching in a parade versus people walking about a piazza. In the case of the parade, there is one person

who is in charge of directing every person's efforts and leads them down the streets along a predetermined route. The individual parade members walk in step with one another in a wholly predictable manner and the parade can usefully be thought of as a single, acting unit despite the fact that it is, in fact, comprised of several individual people. A piazza, however, might have the same number of people as the parade and yet someone observing this from above would see a tangled mess of people moving about in seemingly chaotic fashion. These people are all responding to the paths of other people, which may require them to adjust their paths in order to avoid bumping into other people, but everyone is able to successfully navigate this chaos and arrive at their destinations.

Modeling a piazza as if it were a parade would require that the modeler had perfect access to all the hopes and desires of each individual person and also the ability to perfectly predict whom they would bump into and what their response (deviating to the left/right or adjusting their pace) would be to various potential problems (and when those problems would arise) and would be committing what Resnick (1994) describes as the centralized mindset. Further, in order to form any judgment about the efficiency of this sort of emergent process, the modeler would have to have access to a social welfare function which they simply do not have. As Hayek (1937, 1945), describes, knowledge that would be relevant for the construction of a social welfare function is tacit, unique to time and place, and wholly uncommunicable outside of the context of a market. It is the market, and specifically the price mechanism, which allows for the tacit knowledge and subjective values of the individuals to be transformed into an objective array prices which serve as a sort of information surrogate, containing all of the relevant information for economic calculation therein. Absent this knowledge, a social welfare function cannot be constructed and without a social welfare function to determine what *should be* there can be no discussion of the (sub)optimality of any particular observed outcome just like it would be absurd to talk about the efficiency of people moving about within a piazza.

As a point of illustrative departure, imagine a situation where every individual citizen receives the same amount of public goods and pays the same amount of public costs (taxes)

such that the total cost of the program is divided equally amongst all citizens.⁶ Here, any increase in the provision of public goods is enjoyed by all with the ensuing increase in the cost of providing said benefits similarly felt by all. With homogeneous people, sharing a common utility function and a common array of constraints, whether a good is provided publicly or privately is of no concern - each proposed marginal change will either receive unanimous support or zero support, in a way that resembles the unanimous consent that is often attributed to private market outcomes. Further, the expenditure and spending decisions are brought into alignment by virtue of the rule that any increases in costs are shared equally among all persons.

However, the real world is not populated by homogenous individuals in this fashion - oftentimes, people cannot even agree on whether something is a good or a bad (e.g. tobacco products). Further, in the political setting there is no necessity that any proposed change receive unanimous consent - only a sufficient amount is necessary, and yet the cost of that change would be felt by all. For example, under a simple majority rule standard, any additional outlay that provides greater marginal benefits than costs to fifty percent plus one persons will be enacted, despite the fact that fifty percent minus one persons find that increased outlay to be too costly. This grants a degree of scope in which politicians are able to provide benefits to politically organized or connected groups while imposing those costs on the population in general.

In this framework, though, it can be reasoned that there would never be persistent deficits. There may be welfare considerations to take in mind, but the difference between public expenditures and public revenues would remain narrow, occasionally being out of step owing to the difficulty of predicting exact expenditures ex ante and depending on the form of taxation used to raise these revenues, there may be some error here as well.⁷

Under this scheme, the size of government would tend to increase as the majority is a

⁶A more rigorous treatment of this can be found in Buchanan (1964)

⁷for example, a head tax would be easy to predict as the product of the number of people being taxed and tax rate. An income tax, however devised, may introduce some degree of uncertainty as Congress would have to estimate the total income earned by each individual and multiply this by each person's effective tax rate.

fluid construction as it can be comprised of different individuals depending on the issue being decided upon. For simplicity, suppose that there are three individuals who must decide on additional public provision of two different goods, corn and guns. Their preferences are given in the table below, with an X indicating that a person finds the increase in benefit worth the cost for the public provision and an O representing a person finding an increase in benefit to not be worth the increase in cost:

	A	B	C
Corn	X	X	O
Guns	O	X	X
Both	O	X	O

Figure 4.4: Intransitive Median Voter

In the vote for corn, *A* and *B* would constitute the majority while *C* would constitute the minority, with corn ultimately being approved for public provision despite *C*'s objecting. In the case of guns, however, *B* and *C* would constitute the majority while *A* would constitute the minority. Again, guns would be provided despite *A*'s objecting. Because the majority is fluid and not necessarily made up of the same people each time, but is instead made up by the same *number* of people, democratic governments will tend to expand in the number of goods being provided out of the public purse. This purse can, again, be reasonably expected to be sufficiently full so as to provide for these goods under this scheme. We can also observe that the majority here prefers to have only one good provided publicly instead of two, and so the hypothetical median voter in this model violates the standard definition of rationality in that as it would choose to have both despite preferring to have only one. This provides the underlying logic for splitting bills in Congress, as illustrated by the 2013 Farm Bill, which initially contained provisions for both subsidies to farmers as well as putting in place tighter work requirements in order to receive food stamps. In this form, the bill failed with a vote of 234 against, 195 for on June 20, 2013. The bill was then split into two bills along these issues, with its constituent parts passing on July 11 (farm subsidies portion) and September 19 (food stamps portion). As should be obvious, there is a great deal of explanatory power that can be advanced in this framework.

However, the real world is not constituted in this manner. While there is a greater degree of similarity between the provision of private goods and public goods than is commonly recognized, there is also a great deal of divergence. Further, in recognizing this divergence, a greater understanding of why the size and scope of democratic governments tends to increase over time can be gained. Take, for example, the recognition that purchasing and spending decisions are made separately in Congress. What this means is that individual politicians cannot be judged on the overall effectiveness of Congress to solve society's problems as the collective outcomes are emergent phenomena. Instead, what they are judged on is their ability to provide a greater number of services to their respective constituents while simultaneously imposing as little costs on their constituents as possible. Harking back to the discussion of the hypothetical two stage process of taxation as discussed in Hebert and Wagner (2014), stage one would be the recognition that there are collective wants which entail collective financial obligations. Stage two, however, is where politicians and voters provide a myriad of justifications for benefits in excess of those recognized in stage one while simultaneously claiming a degree of exemption as being proper. Reasons for this abound, from being particularly harmed by pollution to being in a dire financial situation or some other exception.

Even a cursory look at US policy, for example, reveals that this notion is alive and well as not everyone enjoys the same benefits of government activity nor feels the same costs of government activity. Some studies go so far as to suggest that anywhere between 46% and 51% of the current US population pays zero federal income taxes.⁸ With the power to tax different individuals at different rates comes the ability to discriminate on the part of the tax-imposer. This body can, effectively, shift taxation from persons who are strongly connected to government in some fashion and onto those who are weakly associated with government. Similarly, they can concentrate benefits on those that are well-organized and away from those that are unorganized. One of the weakest groups in a democratic body would be future generations, which, owing to their current non-existence, have literally zero

⁸Joint Committee on Taxation, Information on Income Tax Liability for Tax Year 2009 memorandum, April 29, 2011.

say in political outcomes. It should be no surprise that therefore democratic bodies with the ability to engage in deficit-finance tend to do so. But they do not engage in 100% deficit spending, as at least some citizens still pay taxes today.

While it is certainly the case that certain members of political processes (such as the chairman of a committee) exercise a great deal of authority and power, they do not wield infinite power. A single person cannot, for example, simply create a policy by himself and enact it. In order for him to get what he wants, he must garner sufficient support in the form of votes, which often entails vote-trading or logrolling. This is not necessarily a good or bad thing, but is a reality of the world nonetheless. But what this does mean is that the no one person has sole ownership of the “property rights” to make a decision - these rights are distributed among various people within Congress, as Wagner (1992, 2007a) and Yoon (2000) describe. And yet, these scarce resources must somehow be allocated.

As a result of their scarcity, there will be competition along some dimension to provide benefits to some people as opposed to some other people while also competing to impose costs on one group of people and not other people. For example, one politician must decide whether he will want to provide benefits to, say, the automotive industry or the agricultural sector while recognizing that he cannot provide benefits to both. Similarly, politicians may recognize that someone must pay the tax, but will have to decide which group of citizens will pay the tax and which will not. In the same fashion, every politician would like to provide 100% of the public purse to their constituents while imposing 0% of the costs on their constituents. Such a bill is, of course, untenable as such a bill would receive only one vote where a majority is required. Therefore, a politician who proposes a bill is going to have to compromise in some fashion in order to garner a sufficient amount of votes to get the bill through the parliamentary assembly.

Compromise, in this sense, is a political analogue to trading with someone, as both parties are left with at least a portion of what they would like to receive, which is better than the alternative of receiving nothing. However, there is a sharp difference which should be noted - in private markets, the objects being traded are owned entirely by the people

trading. In politics, this is not the case, as they are trading shares of someone else's property. Further, there is no one person who owns the public purse, giving rise to the fiscal commons, as Wagner (2012) describes.

In recognizing a commons, we can hark to the discussion found in Ostrom (1990) and can analyze the emergence of institutions to govern these fiscal commons. Here, the resources that constitute the commons would be allocated in a transactional process or processes. Over the years, a complex process of determining allocation of these common resources emerges. But what are the resources which must be allocated?

At a fundamental level, all parliamentary activity can be described as appropriating funds or expropriating funds in a parasitical nature. These can take a myriad of different shapes, such as providing the rule of law, national defense, roads, and the like but these are all appropriations. Even regulations can be easily worked into this framework - government has merely eliminated itself as a middleman in a transaction between unwilling buyers and desiring sellers.⁹ Therefore, the resources that are being allocated must be the resources from the public purse, with that purse also needing to be stocked somehow.

When governments are small in scale, the resources in the common pool can be allocated in a way that comports with the common view of politics - the entire parliamentary assembly hears a bill, be it an appropriations bill or a tax bill, and subsequently votes on it. There may be some degree of logrolling going on in the background, but this would be relatively minor in nature as the benefit of engaging in said activity would be limited due to the small scale of government. Further, any politician could, in principle, bring forth any bill or raise objections to the terms of the bill at any time during the process of drafting the bill. However, democracies tend to increase in scale and scope over time owing to several factors, chief among them being the fluidity of the majority discussed above. As governments and their role in shaping the economy grow in size, it becomes wholly impractical for an entire governing body to be involved in every step of every bill. Some demarcations are going to

⁹It is worth mentioning that it cannot be the case that all buyers are unwilling, as a majority of people must approve the regulation, but these people are not burdened by the regulation; they are doing what they would have done absent the regulation.

arise in the form of committees assigned to drafting and designing specific types of bills. There may be a committee on healthcare, a committee on agriculture, a committee on energy, and so on, with each committee given jurisdiction over bills considering specific subjects. There may also be overlap across committees - for example, a bill considering the provision of specific agricultural subsidies for medicinal purposes could be a joint product of both the committee on agriculture and the committee on healthcare, at the very least. Once a bill passes the committee stage, the bill is then voted on by the full parliamentary body. Competition over these common resources will therefore take place along two dimensions. The first being within the individual committees as members of the committee vie with one another to secure benefits for their individual constituency and party. The second being across committees as 1) different committees attempt to secure the greatest share of resources for their committee to use at their disposal and 2) committees attempt to secure a sufficient number of votes in the entire parliamentary assembly to get their bills passed. Each of these will be briefly considered in turn. For simplicity, assume that there is one parliamentary body with politicians belonging to one of two parties and that there is no executive body that must sign a bill into law - whatever a majority of the full parliamentary assembly approves instantly becomes law.

Intra-committee competition describes the competition that takes place among politicians within a specific committee. Here, the goal of each politician is to secure benefits for his constituency. The committees constitute a sort of team which operates in some fashion to produce a collective outcome in the form of a proposed piece of legislation. Like all teams, there must be some means of detecting and punishing shirking on the part of individual team members. As a means of solving this, committees typically elect a chairman, who bears ultimate responsibility for the actions of the committee as a whole. This person may be elected by the committee or by the parliament as a whole, with different mechanisms influencing the behavior of committee members as they seek appointment to this position which may lead to opportunism. One way to solve this, which seems to be a norm across parliamentary systems, is to appoint the longest serving member of the majority party to

chairmanship.

Each committee, once created, is given jurisdiction over the creation of bills pertaining to the specific nature of the committee. This committee process has the effect of limiting which politicians are allowed to contribute towards the writing of a proposed piece of legislation. Recalling de Jouvenal (1961), this means that a smaller number of people will be able to have a greater amount of time to speak at meetings, allowing them to fully articulate their points. However, the committee selection stage only provides a limit of which members of the parliamentary assembly can be invited to speak, it does not choose who actually receives an invitation to speak. This is done by the chairman of the committee. In his role as chairman, this person wields significant (though not infinite) power over the committee in the form of setting the agenda, calling meetings, inviting outside experts/witnesses for testimony/research, etc and in a sense frames the discussion that the entire committee will be having on each specific bill.

In order to pass the committee stage, a proposed bill must receive the support by a majority of the members of the committee. In an attempt to garner a sufficient amount of votes, members of the committee may have to include special provisions for specific members, thus raising the benefit of voting for the bill relative to the benefit of opposing it. The nature of these provisions can range from including specific industries in a bill or exempting from taxation specific activities, depending on the type of committee and the bill being considered, but their effect on the politician's home district is the same - additional funding that would otherwise not be available in the form of a stimulus to specific industries which spurs business activity and job creation, with these factors playing a large role in helping politicians get reelected in subsequent terms. Members of the committee can also trade votes across bills, exchanging support on a current bill for support on a subsequent bill. Because voting is done openly and is directly observable, individual politicians have a strong incentive to follow through with their promises in order to ensure continued exchanges of this nature in the future.

Once a bill passes the committee stage, it is then considered by the full parliamentary

assembly. At this stage of the process, all that can be inferred is that a sufficient number of politicians within the committee have found that they stand to gain more by voting for the bill than they do against the bill. If the bill garners sufficient support from the entire parliamentary assembly, the bill then becomes law. If it does not pass this stage, however, the bill is sent back to the committee to be reworked.

Inter-committee competition refers to the competition among committees to secure funding for their operations. To accomplish this, most parliamentary assemblies in the world today have created an overarching committee that is charged with allocating the funds of the public purse to the various committees. Membership on these types of committees is highly sought after, as this committee wields significant power within the parliamentary body. However, this is only an initial endowment of resources *to committees*, not *among committee members*.

In order to fully secure an allocation of resources to particular members of committees, the bill must not only garner sufficient support at the committee level but must also garner sufficient support at the parliamentary level in order to be enacted into law. In this sense, votes of the full parliament can be secured by including provisions in bills that benefit politicians that are not members of the committee itself or by, again, trading votes across bills. These politicians could trade provisions across bills in a type of quid pro quo arrangement. For example, a politician on a committee dealing with agriculture could include support for, say, corn subsidies that benefit a member of the energy committee if that energy committee member will include support for, say, coal subsidies that benefit the agriculture committee's constituency in a separate energy bill. Stratmann (1995) posits that political parties arise in part to facilitate and coordinate these vote trading efforts, with individual politicians trading votes along party lines to aid in getting bills passed through the parliamentary body. This has the further benefit of helping to secure majority status within the parliamentary assembly in general, which confers the added benefit of chairmanship of committees.

Even in this simplified version of a parliamentary system, there is significant scope for and a potential necessity for trading votes in order to secure a favorable distribution of the

public purse by individual politicians. As a large literature describes,¹⁰ this vote trading can take place upon multiple dimensions, as politicians can either bargain with one another by directly inserting specific provisions in proposed bills or by trading votes across bills. Further, this vote trading can take place both at an intra- and inter-committee levels.

To illustrate this, consider but one parliamentary assembly: the United States Congress.

4.4 Congress as a Catallaxy

Consider the fact that at the very least, 537 people are currently involved in the passage of a bill.¹¹ In order for any group to make a decision, there must be rules governing their interaction amongst one another. Imagine putting these 537 people in a conference room and telling them to decide on something. They would first have to figure out by what means (majority vote, dictatorial charge, or physical combat, for examples) the decision will be made (Brennan and Buchanan, 2000). A typical Congress considers over 10,000 bills per year, having the full Congress discuss each bill at every stage of production would be untenable. To solve this, Congress has adopted a form of committee system, where various committees are tasked with thinking about specific types of bills. With respect to taxation, there are several committees involved. In its simplest form, there are the Committee on Ways and Means in the House of Representatives, the Senate Finance Committee in the Senate, and the Joint Committee on Taxation with membership from both houses. Today, there are a total of forty-seven standing, special, and joint committees in Congress.¹² But where did this process come from and how does it actually work?

The Committee on Ways and Means, as it exists today, was first established in 1795.¹³

¹⁰e.g. Wilson (1969), Stratmann (1992), and Doran (2007)

¹¹435 representatives in the House of Representatives, 100 senators in the Senate, one Vice-President, and one President

¹²There is also a separate, “legal” committee, called the Committee of the Whole in the House of Representatives, which is made up of the full House. This allows the full House to technically be governed by separate rules of procedure that typically govern House meetings, one example of which is the ability to debate privately and not have votes formally recorded.

¹³There was a Committee on Ways and Means established in 1789 but it was quickly disbanded, leaving the Secretary of the Treasury ultimately in charge of proposing fiscal policies, including taxation, to the entire House.

This Committee is explicitly empowered with the exclusive authority to bring proposed tax laws to the attention of the full House, meaning that all tax policies must originate here. In order to draft tax legislation, the Committee must have some idea that there is a problem in the current tax code that must be remedied. Typically, these problems are identified by the President in his State of the Union address or the Economic Report of the President, though they are also occasionally identified by special interest groups bringing to the Committee's attention.¹⁴ Once the Committee has a notion of what problems they are attempting to solve, they must then set about finding a solution. To aid them in this process, they hold several meetings. At each of these meetings, several people are afforded the opportunity to speak. The first person to speak at every hearing is the Secretary of the Treasury followed by the Director of the Office of Management and Budget. Several other Administrative members are often invited to speak as are businessmen affected by the proposed legislation. Each person is asked to submit a report and give a testimony based on said report of the impact of changing the tax law on either the Federal government's budget or on the effect that the tax would have on the industry.

Once these meetings are conducted, the Committee retires to its offices in what is called an "executive session." During this time, the proposed bill is marked up for changes in a public meeting, often with staffs from the Treasury and the Joint Committee on Internal Revenue present. Once the markups have been completed, a new version of the proposal is presented to the Committee for approval. A simple majority is sufficient to move the proposal to the final stages, where a final version is drafted along with a report. This draft and its report are then submitted to the full House for approval or rejection. During this time, the House members are not allowed to propose any changes to the bill.

Once the bill passes the House, it is submitted to the Senate Finance Committee, which was originally created in December of 1815 as "The Committee on Finance and an Uniform National Currency" and gained jurisdictional authority over all appropriations bills

¹⁴see the vast literature on rent-seeking (Tullock (1967), for example) for a more detailed explanation of why special interest groups would do this

in 1834.¹⁵ Like the House Ways and Means Committee, this Committee has the exclusive power to bring bills dealing with taxes before the Senate. Put another way, no bill dealing with taxes can be considered by the full Senate unless the Senate Finance Committee has brought it forth.¹⁶ Once the Senate Finance Committee has been given a bill from the House, it then proceeds to deliberate about the effects of the bill. To aid them in this process, they hold hearings that are nearly identical to the Committee on Ways and Means hearings, with the difference being in the version of the bill that is being discussed and (potentially) different members of the Administration and businesspeople. The Secretary of the Treasury is similarly required to be present and granted the right to the first testimony. The Finance Committee collects the written testimonies as well as the verbal testimonies of the panel members and retires to executive session in a similar fashion to the Ways and Means Committee and marks up the bill for any changes. Once the bill has been marked up and the changes (if any) have been incorporated, a new version of the bill is drafted and submitted to the Finance Committee for approval. Again, a simple majority is sufficient to bring the bill to the attention of the full Senate. Once the bill is on the floor, the individual members of the Senate are allowed to propose changes to the bill. Once every Senator has had his say, a simple majority of the Senators present is enough to pass the bill. Once the House and the Senate pass identical versions of a bill, it then goes to the President for signing or veto.¹⁷

The Joint Committee on Taxation was originally formed as a temporary Joint Commission on Taxation tasked with “[investigating] and [reporting] upon the operation, effects,

¹⁵It was customary to refer all appropriations bills to this Committee regardless, but several times the lack of jurisdiction led to several heated debates on the Senate floor as various members wanted various bills referred to their committee(s) instead of the Finance Committee.

¹⁶The Senate Finance Committee, however, does not have the authority to refuse to bring a bill before the full Senate. They must present a bill once presented with a tax bill from the House, however even this version presented may be radically different from the House version

¹⁷Cases where the House and the Senate pass different versions of the same bill are dealt with via conference committee, which is not a standing committee. To determine who sits on the conference committee, the Speaker of the House appoints conferees from the House (as many as he wishes) and the President of the Senate appoints conferees from the Senate (as many as he wishes). The number of people appointed by each house is irrelevant and can differ, but is usually kept small so as to expedite the process. The Conference Committee then holds as many meetings as are necessary, one of which (usually the first one) must be open to the public.

and administration of the Federal system of income and other internal revenue taxes and upon any proposals or measures which in the judgement of the Commission may be employed to simplify or improve the operation or administration of such systems of taxes” per the Revenue Act of 1926. The role of this Commission has since expanded; since 1974, this Committee has also had jurisdiction over creating the official revenue estimates for all tax legislation to be considered by Congress and, beginning in 1986, the Committee is now required to make reports to the House Committee on Ways and Means and the Senate Committee on Finance and to the general assemblies of these chambers on the results of their investigations and studies and to make recommendations, per §8022 of the Internal Revenue Code of 1986. Members of this Committee are present at hearings held by the House Committee on Ways and Means and Senate Finance Committee to answer questions and provide analyses. They are also present at every stage of the bill’s writing, which includes the mark-up sessions and at the conference sessions as necessary, where they present analyses of all provisions in the bill as well as responding to various questions

This brief description of but three committees involved in taxation is an attempt to provide a sense that a process-based approach is necessary in order to understand the origins of tax bills, with its implications extending also to expenditure bills. In recognizing the above, the focus of public finance shifts to address the question of how the things that we call “expenditure bills” and “revenue bills” brought about and how this differs from the way that private goods are brought about.

One way to imagine this would be to think about the production of bills as being a sort of team production, where a group of people work together as a sort of team, similar to a business unit working together to produce a joint outcome. Within the business realm, it is of course not the case that every single worker at a business is involved in every single decision of that business. Tasks are delegated from the top down to some specific business unit to handle, frequently without the CEO actively delegating those tasks himself. For example, issues related to the computer network are delegated to the IT department, which has a staff associated with it. These people on this staff have typically received years of

specialized training in order to acquire the necessary skills associated with their particular task at hand; courses in topics such as “database management” or “network diagnostics” and the like. They are also hired as a result of their demonstrated ability to produce a desired outcome in a cost-efficient manner, with promotions going to those people who have demonstrated a pattern of being better than their counterparts. As is the case in any team-based endeavor, there are bound to be monitoring and associated principle-agent problems which must be overcome in some fashion. To this end, Miller (1992) provides perhaps the most complete discussion of various means to solve these problems in particular circumstances. The end result is that these problems are solved and someone at the top is simultaneously willing and able to terminate employment should an employee fail to deliver the desired result in a timely and efficient manner.

Contrast this with the realm of politics. Here again, we have a multitude of tasks that Congress would like to see accomplished with the overarching goal being to provide things for the “common good.” These may be things such as roads, education, healthcare, defense, energy, or agriculture, to name but a few. Congress, like businesses, has adopted a common practice of having various units that are tasked with accomplishing specific assignments. In politics, we call these units “committees,” but at a functional level they are essentially the same as departments within firms. Just as the IT department handles all aspects related to information technology within the firm, so would the committee on taxation handle all matters related to taxation brought before the parliament. These committees would similarly be comprised of various people, but note that there is no certain requirement that these people be experts in their committee’s assignment. Take, for example, the long-standing presence of Ron Paul on the US Congress’s Joint Economic Committee. Dr. Paul was certainly interested in economics, but he had no special training and had never demonstrated any degree of proficiency at economics. And yet he was, up until his retirement, one of the longest standing members of this committee. In fact, only two of the twenty current members of the Joint Economic Committee has even a bachelor’s degree in economics,¹⁸

¹⁸Justin Amash R-MI and Richard Hanna R-NY

with the most popular college major being the nominally-related field of political science. To be sure, some have gone on to law school or other advanced degrees in subjects such as mechanical engineering,¹⁹ mass communications,²⁰ and marketing.²¹ To be sure, firms can and sometimes do hire people who lack specific training but have demonstrated a proficiency in the area at a different firm. The political analogue, at the federal level, would be to look to the congressman's previous appointments in state legislatures, for example. If the federal politician had previously served in the state legislature on a similar committee and had done well, that would constitute evidence that the federal politician had at least a base level of competence.

Once the members of Congress have vetted candidates that are deemed to be particularly well-qualified, they then need to consider the hiring process in the assembly. There typically is not one person who is given *carte blanche* authority to appoint any person to any position on any committee. Rather, this is accomplished through a separate committee's decision and then confirmed by the entire Congressional chamber. This separate committee may be selected as a representative sample of the entire chamber or it may be done along party lines, e.g. the Republican party nominates Republican members. To be sure, it is rare that only one person is involved in the hiring process at a private firm, but the difference between these two realms is that in the private context the other members of the hiring process serve as advisors who may exercise a degree of veto power in the form of strongly suggesting that a candidate (not) be hired, but the ultimate decision authority on hiring decisions lies with the owner of the firm. If he wants someone to (not) be hired, that person will (not) get hired. In politics, however, the party itself selects nominees for appointment through some process, with no one person having veto power, and this appointee is then confirmed by the entire parliamentary chamber. Here, members of the chamber explicitly do have veto power in the form of their vote but there is no one person who can override the parliament's collective decision. Getting a politician appointed to a position therefore

¹⁹Martin Heinrich D-NM

²⁰Kevin Brady R-TX and current Chairman of the Committee

²¹Sean Duffy R-WI

entails garnering a sufficient amount of support for that person's appointment. In the context of a private business, this would be accomplished through some process by which someone provides evidence that the candidate will be a valuable member of the team and contribute towards the overall mission of the organization. The organization's method of making profit would be clear - find ways to improve the quality of the product relative to its cost or find ways to reduce the cost of production. They would not, however, quibble about what product the firm should produce, only perhaps the manner in which improvements to the product would be made. In politics, however, there are members who have radically divergent beliefs on what product the parliamentary assembly ought to produce in order to benefit the populous. Effectively, a person who is somehow recognized as being quite good at getting bills passed may end up having a tough time getting through the appointment process as opposing party members would want to try to reduce their opponent's ability to get their bills through. In a contested Congress, where the majority party has only a slight majority advantage, the minority party has a much greater chance of blocking an appointment. If one party enjoys a substantial majority in the parliament, this would be of less concern for the majority party. Promotions in the political context go to the members of the committee who have served on that committee the longest, regardless of how long they have been elected to their representative position.

As should be clear, the process of creating a tax policy is not the result of any one individual choosing anything nor is it even the result of any one committee, but is instead a product of various interactions among various politicians. Who gets to speak and when is determined by the rules that Congress faces in selecting committee members as well as the individual congressmen operating within those rules (e.g. the agenda-setting power given to chairmen of committees and subcommittees). To say that tax policy is created by any individual or that this process even remotely resembles the choice of an individual is to commit the fallacy of the centralized mindset (Resnick, 1994) and to fundamentally misrepresent how tax policies are actually created.

We can envision this process as growing in a similar fashion to a tree. In the beginning,

when governments were relatively small players in a national economy, the decision making process would have been quite simple and may not have been radically different from the decision making process in a private market setting, save for the absence of market prices to guide decisions. Buchanan and Wagner (1977) describes this as the the pre-Keynesian “old-time fiscal religion” whereby two principles were recognized: 1) that resorting to government debt represented “government profligacy... that imposed fiscal burdens on subsequent taxpayers” and 2) that individuals could make informed decisions about “proposals for public expenditure only if they were confronted with [the] tax bill at the same time.” The authors note that “effective democratic government requires institutional arrangements that force citizens to take account of the costs of government as well as the benefits, and to do so simultaneously.” This period of time would be represented by a young sapling. There may be a branch or two of departure, but the industrial organization, in a manner of speaking, would have been relatively simple and straightforward. Moving from the tip of one branch to the tip of another could be done without much difficulty and certainly wouldn’t require much of a map or even experience working within government. This would be to say that, when an issue came up that required the attention of government, it was relatively simple for a collective decision to be rendered. Everyone in Congress knew which office to go to and which person within that office to speak to because there simply were not that many people to remember and not that many complicating factors.

As time went on, however, this tree grew as the role of government in the economy expanded. New branches sprouted off from the trunk of the tree as well as from old branches while some branches joined and then subsequently split in new ways. Now, moving from the tip of one branch to the tip of another branch would require significant planning and strategizing. As there is no single road map to creating policy, what would be necessary would be to acquire experience as quickly as possible or to surround oneself with experienced personnel. To facilitate this, first-term congressmen are typically given the role of “acting speaker/president pro tempore,” where they act as Speaker of the House or President of the Senate on a temporary basis (sometimes as short as one hour) so that they can learn

proper parliamentary procedure.

4.5 Conclusion

This essay has presented a different way of thinking about the process by which a public goods are provided and financed. This way, which I call “catallactic public finance” builds off of previous literature by De Viti De Marco (1936), Buchanan (1949), Buchanan (1967), Buchanan (1979), Wagner (2007a), Wagner (2010), and Hebert and Wagner (2014), among others. The unique insight is that the provision of public goods, including the means of financing them, is only tangentially illustrated by way of modeling it in the standard Samuelsonian optimization framework which dominates the profession today. The Samuelsonian framework is one that explicitly views economics as the science of resource allocation, and as such is well-suited for analyzing social interactions as a calculus. There is a unique point that is superior to all others from a societal view. This must be so because as it simply wouldn’t make sense for there to not be - it would be akin to saying that there exists a mountain with no summit. The economist’s job, then, is to use his unique, gods-eye-view to discover this point and to lead society to this summit through policy analysis and institutional craftsmanship.

Instead, catallactic public finance posits that policies have an emergent quality to them, as they are the product of a process similar to (but still different from in meaningful ways) a market process. There are people, whom we call politicians, operating within a framework of rules with but limited knowledge. These people bargain and exchange with one another in a pattern that is intelligible to an outside observer through the view of economics as the science of exchange by understanding that man has a propensity to truck, barter, and exchange within a given institution. In this intellectual framework, there is no mountain to be summited. Applying this insight to the realm of public finance is therefore to reject the notion of some chooser (including a hypothetical median voter) selecting a point within the public/private goods space and instead seeks to describe the process by which policies are crafted. Instead of discussing what decisions were made in the political setting, it would

instead call for a description of *how* those decisions were made, with the actual decisions themselves being of secondary importance.

What this essay therefore calls for is a reawakening of the field of public finance in the image as laid out in De Viti De Marco (1936) and other Italianate scholars. Public finance would cease to be a field seeking to optimize the basket of public goods and private goods selected by society and would instead become a field that seeks to understand how the current allocation came to be. This does not mean that economists studying public finance in this vein would have little to contribute by way of policy. Rather, economists would be in a seat to highlight potential problems with proposed solutions in terms of both knowledge and incentive problems. Recognizing this would recognize the limits on what the economist would be able to authoritatively say. Pretending that these limits do not exist, however, and attempting to operate outside of them, as is so often done, is perilous in its own right. Further, recognizing limits and subsequently operating within these limits would ultimately allow more good to get done with less effort.

One possible future of this literature would explore the attempts by various economists and politicians to operate outside of these limits and what happened as a result. For example, in the quest to bring about an optimal tax policy in the style of Mirrlees (1971), much economic knowledge was assumed on the part of the modeler about the various ways in which ordinary people would respond to changes in the tax policy. Assuming this knowledge turned out to be unwarranted, as the modeler did not have access to the unique and tacit knowledge of the individuals. This, in turn, led to the release of technical amendments designed to address the issues with the first tax policy and to bring peoples behavior in line with the model. However, as time went on and more of these technical amendments were added, the volume of rules constituting “the tax policy of the United States” grew to such epic proportions that no person can ever be sure that they are following the letter of the rule nor can an oversight organization efficiently check each individual’s compliance with the policy.

Another way to take this would be to explore the process by which parties attempt

to secure majority control of a chamber through the process of vote trading across bills. Party leadership must have some means of coordinating votes across members in such a way that aligns the long-term interests of the party with the short-term interests of the individual politician. This could be accomplished through several ways, including direct vote transfers, financial support for reelection campaigns, possibilities for support for higher, more prestigious offices, and the like. Yet another avenue for this branch would include a discussion of private policy analysts operating think-tanks and the incentives that they face. On the one hand, one would think that seeking the truth regardless of ideological beliefs would be a profit-maximizing strategy. On the other hand, politicians are only going to invite panelists who can effectively argue on their behalf - bringing in someone to testify against your position would be absurd. As should be clear, the catalytic approach to public finance is one that is open to a wide range of continued research.

Chapter 5: Conclusion

This dissertation started with a central question of “why are tax policies around the world so complicated?” Answering this question requires a discussion of both taxing and spending which are normally thought of as being two sides of the same coin. However, the nature of politics is such that this link is severed, as Buchanan (1967) describes.

Traditional literature on this topic, even the existing literature which loosely views economics as a science of exchange and the institutions within which those exchanges take place, asks the question about what the stated ends of an organization are and addresses whether or not those ends are met through the chosen means. Within this literature, the government is viewed and analyzed as an organization with a hierarchical structure of residual claimancy and decision rights. In this respect, the ends of the organization are either divined by the analyst or assumed, with the caveat that these assumed ends generally map well into what reasonable people would state as the goals of policy. Traditional analyses have then proceeded to analyze the political institutions in much the same way that we would analyze the “institutions” of a private firm. Insofar as the political institutions fail to achieve the desired ends, there are two explanations: 1) the ends that were assumed going into the analysis are not, in fact, the ends that the politicians have in mind or 2) the institutions fail to provide the necessary feedback to enable politicians to achieve their desired ends. The former calls to mind the image of the malevolent politician who uses public office to benefit himself and his friends at the expense of everyone else. The latter calls on the economist to determine what the optimal rules are and to then advise politicians on how to bring about those rules. These are not mutually exclusive, however they are separate discussions. It is important to highlight that whatever positive analysis is done in this strand of research is done against a backdrop of normative beliefs about what government ought to do.

This dissertation takes a different approach. Instead of viewing government as an organization, this work approaches it as an order, in the same fashion that Wagner (2007a, 2012) do. In doing so, government is viewed as being comprised of several individual people with but limited knowledge not just of what is contained in any given bill but also limited knowledge of time and place. Groups, as Brennan and Buchanan (2000) note, cannot make decisions – only individuals can. What is necessary for a group to make a decision, therefore, is a framework of rules that transforms the individual wants and desires into collective wants and desires. This framework of rules within parliamentary assemblies, and its accompanying communal property rights structure, deserves primacy in the quest for explaining observed political outcomes as it determines who gets to speak on which issues and at what steps of the writing stages of a bill, which implies that changes in these rules will produce different results as illustrated by looking at the United States and the United Kingdom circa 1976-1982.

When governments are relatively small players in an economy, it seems reasonable that very little organizational structure to a parliamentary assembly would be necessary. As governments grow over time, however, the sheer task of even reading and deliberating on each bill becomes wholly untenable for the individual politician; there is only so much time in a day. What becomes increasingly necessary, therefore, is a hierarchical structure that specifies which group of politicians will be in charge of which type of bills. Today, we call these groups “committees.” This committee system is not a fact of nature and as such must be designed by man somehow and at some time. Further, there must also be some sense of congruency between the committees and the entire parliament - i.e. the committee must demonstrate to the full parliamentary assembly that the bill that they have come up with is agreeable to at least the majority of parliamentary members.

This introduces two stages of competition among politicians. At the first level is the competition among committee members (intra-committee competition) for control over directing resources towards individual members’ constituencies. The second level would be across committees as individual committees compete with one another over the final share

of the collective governing body's purse. Therefore, the puzzle that politicians must solve is not one of "how should the resources be allocated?" but instead "how can I get the resources allocated in such a way that benefits my constituents and by extension me?" This will surely entail vote-trading amongst politicians at both the intra- and inter-committee levels.

What the outcomes of this vote-trading are and the normative considerations of these outcomes that follow are of secondary importance. What is of primary consideration here is the process by which these outcomes emerge. To this end, this dissertation offers a sketch of a purely positive, catallactic treatment of the creation of policy. More work is necessary both in terms of more fully fleshing out this catallactic approach to public policy and in terms of providing analysis of past and present policy outcomes in this framework.

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Curriculum Vitae

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