An Efficient Tax System Works to Ensure the Greatest Possible Satisfaction for the Citizen/Consumer

Chair's Perspective
February 2011

By Dr. Nelson Easterling

The second requirement for a sustainable tax system – after fairness, which was discussed in an earlier Perspective, is the issue of efficiency. In actuality, there are two concerns when it comes to efficiency. The first is administrative efficiency. Adam Smith, in *The Wealth of Nations*, describes this requirement as the need to make sure "taxes are so contrived as to take out and keep out of the pockets of the people as little as possible, over and above what it brings into the public treasure."

In other words, the cost of collection should be a major consideration when constructing a tax system. Since this element of the issue is so closely related to the third requirement of a sustainable tax system, simplicity, it will be discussed at more length in the next paper.

The second element of overall efficiency is economic efficiency. Economists define efficiency as getting the most out of a resource used or the generation of the greatest possible satisfaction from a given amount of resources. In tax systems, it can also be defined as the use of revenue sources that have the least adverse impact on the overall economy.

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Smith spent a great deal of time and analysis on the economic efficiency of various taxes. It was clearly a major concern to him. He reached very few distinct and specific conclusions on individual taxes, but he did come to one general conclusion and one specific finding that should be noted. First, as a general rule, he said that taxes should not be levied against the necessities of life but should target luxuries as much as possible.

His specific tax finding is of special interest at this time. Basically, he argued that taxes on estates that would be passed from a deceased property owner to persons who were not dependent on the taxpayer at the time of his death were not to be avoided. These taxes would not be injurious to the economic system as a whole. He was reluctant to tax estates that would go to support under-aged dependents but not those that would go to anyone else.

Economic efficiency was also a major concern to our Founding Fathers when they created our Constitution. There is a reasonable expectation that our Founding Fathers were familiar at least with the basic concepts contained in Smith's seminal work. It was published in 1776 and was an immediate success. It cannot be proven that they had read the book, but they certainly understood that the source of tax revenues had an impact on all aspects of American life.

It is clear, however, they agreed to a large extent to at least one of Smith's arguments. Specifically, Alexander Hamilton addressed the subject of taxing luxuries in Federalist Paper 36 when he said that protecting the poorer classes from taxation was in the best interests of the government and the nation as a whole. He specifically proposed that taxes should "go as far as practicable in making the luxury of the rich tributary to the public treasury." He said this was the best way to reduce any adverse effects of taxation and help ensure America's future.

Smith's analysis of taxes and their economic efficiency is quite lengthy and based on antiquated tax terms and tax systems. It is difficult, therefore, to use extensive references to his work in today's debates. However, it is clear that he based many of his analyses on an overriding tenet of economics. It is a tenet that is well known, and mostly misunderstood. It is the belief in the power of "the invisible hand" in economics and the market.

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Many people believe Smith was saying that "the invisible hand" was a refutation of governmental regulation of any economic activity. It was not. It was a simple belief that the consumer was a better guide for market activity than was any central authority. The reference to the invisible hand was made in the context of a laborer deciding how to spend his earnings. That individual decision, though made for purely personal purposes, was a better guide for the market than was any analytical decisions made by persons seeking to make economic policy.

In essence, it was a well-founded belief by Smith that a true market economy is a demand economy. Demand is the best, if not the only, thing that can properly guide market actions.

Smith also firmly believed that price mechanisms were paramount to any market economy. That simply means that any governmental decision, including taxes, should consider what effect the decisions would have on prices. Prices are the only external signal the consumer has to guide his actions. The consumer knows his internal needs and desires. But he must rely on prices to help prioritize his economic choices: how much of one good to purchase as opposed to another. The relative satisfaction he gets from one product or one brand versus another must be weighed against what he must give up in order to get that satisfaction. Prices are an important element of all economic transactions.

If taxes (or tax expenditures) affect price, they must be carefully reviewed before adopting them. If tax policy perverts prices, it perverts market choices. If tax policy reduces prices and shifts the cost of a good or service to others than the consumer, consumption of that good or service will be greater than it would be if the price were accurate and true. If tax policy increases the price of a good or service, it will reduce the consumption below market levels. Before setting tax policy, both of these possibilities must be considered.

Perhaps the most important reason to understand Smith's reverence for "the invisible hand" is its relationship to governance. In Smith's world, the consumer is sovereign. Indeed, in the theory of Classical Economics, there is the Law of Consumer Sovereignty. When the market economy is truly working, the consumer is the king. Corporations do not rule. The consumer does.

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Government's job is to make sure that this relationship is not disturbed. When governments try to shift power from the consumer to the producer, it is like trying to reinstate an aristocracy with inordinate power.

Using tax policy to make this shift is oft sold to the citizens as a method of increasing economic growth. In reality, it merely shifts political and economic power.

Dr. Nelson Easterling is a former senior staff member for the Florida Senate. He earned his doctorate in public policy and economics from Florida State University, and has taught graduate courses there in political economics and public finance.