Corporations as Contract and Government Financing in a Free Society

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The philosophy set forth in the fiction and nonfiction of Ayn Rand establishes an underlying intellectual framework for a free society. Rand was like a physicist who deals with broad abstractions about the nature of reality. The engineer then takes these ideas and builds, among other things, the automobile. Also like the physicist, Rand the philosopher dealt with the underlying ethical principles of a free society, but left many of the details of how a government should be "constructed" to future intellectuals in the field of law and jurisprudence.[1] The aim of this paper is to help fill in some of the details as to how a

[1] *These three categories* [of a proper government] *involve many corollary and derivative issues -and their implementation in practice, in the form of specific legislation, is enormously complex. It belongs to the field of a special science: the philosophy of law. Many errors and many disagreements are possible in the field of implementation, but what is essential here is the principle to be implemented: the principle that the purpose of law and of government is the protection of individual rights.* AYN RAND, *The Nature of Government*, *in* THE VIRTUE OF SELFISHNESS, 107, 112 (12th ed., Signet, 1961).

proper government should be constituted. Specifically, this paper deals with the issue of governmental financing in a free society. Those first encountering the Objectivist concept of individual rights will often ask the question: How will governments constituted under such a principle be financed? Academics criticizing the concept of laissez-faire capitalism often speak of a "free rider" problem, creating a "market failure" with regard to government.[2] This problem allegedly requires government officials to take by force property from individuals that those same officials are employed to protect. It is alleged that without *coercive* taxation, government functions cannot be funded.[3] In one of her essays, Ayn Rand presented a glimpse of

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[2] *See* GEORGE REISMAN, CAPITALISM: A TREATISE ON ECONOMICS, 96-98, 97 (Jameson Books, 1996), for a description and critique of the free-rider theory.

[3] I refer to two means for government to obtain revenue. The first is "coercive taxation", which is what most people in contemporary society mean by taxation. The second is "voluntary taxation", which is money paid by citizens to fund government functions that is received by government officials in a manner that comports with the Objectivist principle of individual rights.

how she thought government should be funded in a free society.[4] This paper takes the concept of a voluntary tax on contracts presented by Rand in that essay, and, viewing it in light of the concept of corporate limited liability as a contract, presents a more detailed plan for financing government in a free society.

To show this, it is necessary to understand the essential nature of a corporate business association.[5] The key feature of a corporation that distinguishes it from a partnership or sole proprietorship is limited liability. The limited liability aspect of a corporation in a free society should be seen as nothing more than a contractual agreement between the corporation's owners and their creditors. Even under the current law of most U.S.

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[4] *See* AYN RAND, *Government Financing In a Free Society*, *in* THE VIRTUE OF SELFISHNESS, 116 (12th ed., Signet, 1961).

[5] I prefer the term "corporate business association" to "corporation" because it emphasizes the fact that a "corporation" is not an "entity" existing separate from the people that comprise it. However, for the sake of brevity, I will sometimes refer to a corporate business association as a "corporation", so the reader must keep in mind that this is not an endorsement of the "entity" theory of corporations.

jurisdictions today, the owner of a corporation is normally only liable to the extent of his investment in the corporation.[6] In a free society, this agreement would establish that the creditors could not hold the corporate owners liable for debts incurred in their capacity as owners of the corporation beyond the amount of money that the owners have invested in the corporation.[7] A

See GREGORY A. MARK, *The Personification of the Business Corporation in American Law*, 54 U. Chi. L. Rev. 1441 (1987).

[6] Under current law, the owner(s) of a corporation can sometimes be subject to personal liability if he engages in fraudulent conduct or other forms of bad behavior. This is commonly known as "piercing the corporate veil". *See Edwards Company, Inc. v. Monogram Industries, Inc*., 730 F. 2d 977 (5th Cir. 1984), *see also* PRICE, *Tort Creditor Superiority and Other Proposed Solutions to Corporate Limited Liability and the Problem of Externalities*, 2 Geo. Mason U. L. Rev. 439, 455 (1995). The courts are also more likely to subject owners to personal liability for tort claims brought against the corporation. See EASTERBROOK and FISHEL, *Limited Liability and The Corporation*, 52 U. Chi. L. Rev. 89, 112 (1985).

[7] *A corporation is a union of human beings in a voluntary, cooperative endeavor. It exemplifies the principle of free association, which is an expression of the right to freedom. Any attributes which corporations have are attributes (or rights) which the individuals have –including the right to combine in a certain way, offer products under certain terms, and deal with others according to certain rules, for instance, limited liability.*

An individual can say to a storekeeper, 'I would like to have credit, but I put you on notice that if I can't pay, you can't attach my home –take it or leave it.' The storekeeper is free to accept those terms, or not. A corporation is a cooperative productive endeavor which gives a similar warning explicitly. It has no mystical attributes, no attributes that don't go back to the rights of individuals, including their right of free association. See LEONARD PEIKOFF, The contract for limited liability in a free society could be negotiated by informing all potential creditors that the business owner will deal with them if they agree to hold him liable only to the extent of the assets that he holds in the name of his business. The business owner could establish separate accounting books for the assets and liabilities of the business, as well as a separate bank checking account. The owner of the business could place "boiler-plate" language in all contracts stating that the other party to the contract understands that part of the consideration they are giving is that they are limited to the assets of his business in the event of breach. These and other actions could be taken by the business owner to inform all *voluntary* creditors

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Philosophy of Objectivism Lecture Series, Question Period, Lecture 9(1976), *in* THE AYN RAND LEXICON, *Corporations* (Harry Binswanger ed.).

that their claims against the business owner are limited to the assets of the business.[8]

To better grasp the contractual nature of a corporation in a free society, imagine a hypothetical butcher doing business. A butcher, Bill, forms a business called "Butcher Bill, Inc.", which sells meat. Butcher Bill owns all shares of the corporation. Butcher Bill does business with Farmer Frank. Farmer Frank knows that he is doing business with Bill in his corporate capacity, i.e., that he can only collect debts owed by Bill from the assets set aside by Bill for Butcher Bill, Inc. Farmer Frank

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[8] *See* EASTERBROOK and FISCHEL, *supra*, note six concerning the fact that courts in most American jurisdictions today are more apt to "pierce the corporate veil" in the case of lawsuits against the corporation's owners by involuntary creditors. The best example of an involuntary creditor is the personal injury plaintiff in tort law suing a business for negligence that caused injury to the plaintiff. Given what has been said about the contractual nature of a corporation, it is logical that courts should be more apt to pierce the corporate veil in these cases, since the tort victim deals with a negligent corporation involuntarily. For instance, a tort plaintiff hit by the owner of a corporation who was negligently driving the corporate vehicle on corporate business was not given the opportunity to agree to a contract limiting the owner's liability to corporate assets. Since there was no contract, the plaintiff can sue the owner and recover against the owner's personal assets, which includes the owner's interest in the corporation.

was also given an opportunity to look at the accounting books of Butcher Bill, Inc., so he knows what the assets and liabilities of Butcher Bill, Inc. are. Based on this knowledge, Frank chooses to buy a cow from Butcher Bill, Inc.   If Frank later sues Bill for breach of contract, Frank will only be able to recover from Butcher Bill, Incorporated assets, not from Bill's personal assets.

Now that the contractual nature of the limited liability aspects of a corporation in a free society are understood, it is time to turn to the writings of Ayn Rand on financing a proper government under pure laissez-faire capitalism.[9] In her writings, Rand proposed at least two methods of financing government.[10] The first method she proposed involved the use of a lottery. She said that this had been used with some success in Europe. This

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[9] *See* RAND, *supra,* note 4.

is a common method for state governments in the U.S. to obtain revenue today. The primary objection to a government-run lottery is that it appears to extend the activities of government beyond its proper scope in a free society. If a government could run a lottery to finance itself, then why not a steel mill, passenger airline, or computer software business? Furthermore, government officials could not rightfully prevent others from operating their own lotteries, which would cut into the government-run lottery's profits. This makes the viability of a lottery funding government in a free society questionable.

Rand's second method of funding government in a free society fares better than the first. It is premised on the idea of courts recognizing as enforceable only contracts for which a party asserting a contract right in a breach of contract action has

[10] It should be noted that Rand meant the two methods proposed in *Government Financing in a Free Society* only to be illustrative, and that she qualified them by stating that they might not even be the best methods of financing government.

previously paid a voluntary tax on. Rand described this as a form of government insurance, with the voluntary tax on the contract being analogous to an insurance premium. The amount of the premium to be paid in any case would be a set percentage of the monetary sums involved in the contract. There would be no legal penalty for those who chose to enter into contracts and not pay the premium. But, if the non-payer later decided to assert a legal right under the contract, the claim would not be recognized in a court of law. A simple example of this would be if Bill contracts with Frank to receive a cow in the present in exchange for Bill's promise to pay Frank $10 one week after receiving the cow. Assume that the government was to impose a voluntary contract tax of 10% as a condition of any contract being enforceable in court in the event of breach. Frank would need to pay $1 to the government in the present, at the time the contract is made, for the right to assert a breach of contract claim against Bill if he doesn't pay $10 one week after receiving the cow.[11] Frank would be free not to pay the premium to the government, but the courts would not enforce his contract against Bill in that case.[12]

If the limited liability aspect of a corporation is merely a contractual term of doing business with the corporation, then it would be appropriate for the corporation's shareholders to pay a tax to enforce the limited liability aspect of the corporate contract with lenders, suppliers, employees, and customers. Even under present American law, individuals have a choice of

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[11] I see no reason why Frank couldn't simply promise to pay the $1 to the government at some later date, rather than pay it to the government in the present, but this is an unnecessary complication that doesn't need to be discussed in this paper. Obviously, in such a case, if Frank later didn't pay the $1 he owed in tax, then the government, just like any other party to a contract, could sue him and enforce a judgement for the $1, plus interest, it was owed.

[12] The extent to which Frank could rightfully engage in "self-help" to enforce the contract is an open question in my mind. Even if Frank could rightfully go to Bill's house and seize $10 worth of property, I think he would have to appear before a court in a criminal proceeding and assert an affirmative defense of "contract enforcement", which would require him to go through all of the trouble and expense of proving he had a contract with Bill anyway. This would probably be more trouble than simply paying the voluntary contract tax to the government in

whether they want to do business under the corporate business association, or under the sole proprietorship or partnership.[13][14] Individuals can currently choose whether they want to go into business with limited liability or not. For the most part, only persons operating under the corporate form of business pay corporate income taxes.[15] If corporate owners were not subject to the individual income tax, as they currently are, then they

the first place. For the sake of this example, I am assuming here that Frank would prefer to simply have the courts enforce his contract in the first place.

[13] There are actually other forms of business association in most American jurisdictions today. Other forms include the limited liability company, the limited liability partnership, and the limited partnership. Consult any law school textbook on business associations for a description of these forms of business. What is said about the voluntary-tax-nature of corporations, because of their limited liability feature, would also apply to these three types of business association.

[14] In brief, partnerships and sole proprietorships are the type of business associations that occur when individuals choose not to file any papers with the state before going into business. They are the "default" forms of business arrangement. An individual going into business by himself is defaulted to a sole proprietorship, and a group of individuals are defaulted to a partnership. Unlike a corporation, the owner(s) are personally liable for all debts of the business.

[15] With the advent of new forms of business association such as the limited liability company, it is not always true that business associations with limited liability are subject to the corporate income tax. Also, owners of corporations that are below a certain size can elect for S-corporation status with the IRS, making them exempt from corporate income taxes. But, no traditional partnership or sole proprietorship is subject to corporate income taxes, so it is possible to avoid them by choosing one of these forms of business association.

could choose to operate as either a corporation, and be subject to the corporate income tax, or as a partnership or sole proprietorship, and pay no taxes. In essence, business owners would be able to choose whether to include limited liability in their contracts, and pay a tax for enforcement of that contract term in court in the event they are sued, or to be personally liable on any contracts and pay no taxes.

For the sake of illustration, imagine that Farmer Frank and Butcher Bill both engage in business under the corporate format. Frank sells Bill a cow, on credit. Unfortunately, things don't go well for Bill's business. The price of beef falls precipitously and Bill has to sell the butchered cow he bought from Farmer Frank, Inc. for less than he promised to pay for it. He is unable to pay his debt, and Farmer Frank sues him for breach of contract.   In his collection efforts, Frank will be limited to the assets set aside for Butcher Bill, Inc, but only if Bill remembered to pay his corporate taxes.[16] If Bill failed to pay his corporate taxes in the period in which he breached his contract to pay Frank, then the court will not have to enforce the limited liability provisions of his contract with Frank. Frank will be able to hold Bill personally liable for the debt. Bill would be free not to pay his corporate taxes, but his business would be treated like a sole proprietorship in the event he was sued for breach of contract or was otherwise unable to pay all of his debts to voluntary creditors and the corporation entered bankruptcy.

Now that a tax on the corporate limited liability contract has been shown to be a form of voluntary taxation in an otherwise free society, another issue to address is whether such a tax would take in adequate revenue to fund governmental

[16] Note that it will later be established that, under an ideal system of taxation, Bill wouldn't pay these taxes directly in this situation. Frank, as the party that sues in the event of breach, would pay them. But, Bill would still pay the tax indirectly, since Frank knows he is dealing with a corporation and can adjust the sales price of the cow to reflect the higher taxes that must be paid for contract enforcement of a

functions. This inquiry is fairly speculative, but one method of determining this is to look at the amount of revenue currently taken in by the existing corporate income tax system. Total Federal Government revenues in year 2000 were $1,806 billion. Ten percent, or $180 billion, of that revenue was generated via the corporate income tax. Total Federal Government outlays were $1,727 billion in 2000. Fifteen percent, or $259 billion, of that spending was for national defense.[17] This means corporate income taxes collected at current rates could pay for half of national defense.[18] If total spending by the Federal Government under laissez faire capitalism were $300 billion, then current corporate income tax revenues would only need to be doubled in order to pay for it. Corporate profits in 1999 were $892.7

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limited liability contract. The price of the cow would be higher to compensate Frank for the fact that he is taking on greater risk.

[17] *See* 2001 NEW Y0RK TIMES ALMANAC, 144, (John W. Wright ed., 2001).

[18] I assert that national defense, along with the federal courts, is one of the few legitimate functions of the U.S. Federal government under the current constitution. But this is an issue for another paper.

billion.[19] Thirty-four percent of this figure is $303 billion. Using current economic figures, the most that corporate income tax rates would have to be in order to fund all legitimate functions of the Federal Government are 34% of the total yearly revenues of all corporations.[20] Under pure laissez-faire capitalism, the corporate income tax rate would probably be lower than 34% because of the increase in wealth that would be

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[19] *See* TIME ALMANAC, 2001, 648, (Borgna Brunner ed., 2001).

[20] A brief inquiry into the current system of Federal corporate income taxation should be made at this point. There are four "official" corporate income tax brackets in existence under current Federal law. But, the effect of "surtax" is to create additional brackets for practical purposes. These effective tax brackets are:

15% of the first $50K of Taxable Income
$7500+25% of TI between $50K and $75K
$13,750 + 34% of TI $75-$100K
$22,250 + 39% of TI $100-335K
$113,900 + 34% of TI $335K-10M
$3.4M +35% of TI $10M-15M
$5.15M + 38% of TI $15M-18.3M
35% on any additional TI

Basically, corporate income taxes consist of the corporation's income (revenue) for the year minus any relevant deductions (e.g., start-up expenses, wages to corporate employees, rentals for corporate business, capital expenditures, etc.) *See* DANA SHILLING, LAWYER'S DESK BOOK, 136-156, (Prentice Hall, 11th edition, 2000).

associated with freedom of production.[21] Individual income taxes would be eliminated, which would greatly boost investment and production in the economy. Spending by government would be limited to legitimate functions, which would allow greater spending and investment in the private sector. Individuals formerly on welfare would move into the private sector workforce, shifting from a net drain on production in the economy to a net surplus. Industry would be deregulated, giving businessmen total freedom to produce. All of this would increase corporate revenues, thereby reducing the percentage that must be paid in corporate income taxes to finance the legitimate functions of the Federal Government. The percentage of corporate income needed to fund the Federal Government would be less because the total amount of wealth produced by corporations would be greater.

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[21] *See* GEORGE REISMAN, CAPITALISM: A TREATISE ON ECONOMICS,

It should also be noted that some form of tax on corporate limited liability could be used to fund U.S. State governments. This tax would be justified by the fact that corporations also make use of state courts in enforcing the limited liability terms of a contract. Therefore, they could rightfully be double-taxed, at both the Federal and State levels. Once again, corporate owners could choose not to pay this tax, but state courts would not enforce the limited liability contract.[22]

Although it has been established that corporate taxation in exchange for court enforcement of corporate limited liability is a voluntary tax, the question remains whether an *income* tax is the appropriate method of corporate taxation. Before considering alternative methods of corporate taxation, it is appropriate to

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for a presentation of the economic case for capitalism.

[22] Whether this would be the most effective manner of funding state government is another issue, but there is nothing morally wrong with doing so. Some form of voluntary property tax, or poll tax that must be paid by citizens before they can vote seems, in my mind, like a more appropriate form of funding for state government. This is an issue for another time.

explicitly state a principle for judging alternative methods of corporate taxation. On at least some corporate transactions, a condition of the contract between the corporation and the other party to the transaction is limited liability for the corporation's owners. Therefore, in any transaction where the corporation's owners may later assert limited liability against the other party in court, a tax must be paid as a condition for court enforcement of the limited liability term of the contract. Here, a "transaction" can be a sale from, purchase by, or loan to the corporation. Any other plan of taxation that deviates from this principle is suspect, unless it can be justified on an alternative basis. For instance, poll taxes that must be paid before one can vote are based on the principle that those wanting the protections of government must be willing to pay for it and voting is implicitly a statement that one finds the services of government to be valuable.[23] In addition to judging competing methods of corporate taxation based on the above-described standard, some methods of corporate taxation may be preferable to others because they don't impinge on other fundamental values. For instance, some methods of corporate taxation may be disfavored because they raise privacy concerns.

One possible alternative to taxing corporations' incomes is a tax based on the book value of a corporation for a given period. The corporation would pay a certain percentage of this value at the beginning of a certain time period in exchange for the courts recognizing the limited liability of the owners in that period. If the tax-rate were 10%, then a corporation with assets worth $100 dollars at the beginning of that tax year would pay

[23] *In order fully to translate in practice the American concept of government as the servant of the citizens, one has to regard the government as a paid servant. Then, on that basis, one can proceed to devise the appropriate means of tying government revenues directly to the government service rendered. See* AYN RAND, *Government Financing in a Free Society*, 119.

$10 for limited liability within that tax year. A problem with this method is that it seems to tax corporate owners for sales in period n, which would be the basis of the corporation's book-value at the end of that period, but provides the owners with limited liability in period n+1. This deviates from the principle stated above because the courts would be recognizing the corporation's limited liability for past, unrelated transactions rather than for the transactions that might be at issue in the present. For instance, imagine that Butcher Bill, Inc. pays a tax based on its book value at the beginning of period 2. The book value of the corporation is based on its value at the end of period 1. Butcher Bill, Inc. then sells a side of beef to Eric Eater in period 2. Eric eater then gets sick and sues Butcher Bill, Inc. in period 2 for negligently preparing the beef in a manner that caused it to be spoiled. Butcher Bill is asserting limited liability for a transaction that occurred in period 2, but the court is recognizing his limited liability for taxes paid based on the value of the corporation in period 1. The value of the corporation in period one would have nothing to do with the sale of the tainted beef, which is the basis of the lawsuit. This method of corporate taxation therefore does not tie the period the tax was paid to the period in which limited liability would be asserted.

Another alternative to corporate income taxes would be a tax on the sale of an ownership interest in a corporation. In other words, every time a corporate share is sold on the stock market, the purchaser pays a sales tax. The primary problem with this method is that only large corporations are usually traded on a public exchange. The stock of most small corporations is held by one or a few owners and is not traded on a public exchange. Many of these small corporations are also not likely ever to be sold by their original owners. This means that owners of small corporations would tend to receive the benefit of having their limited liability contract right recognized in court, but would not have to pay for this enforcement.

Another alternative, based on the taxation of individual stockholders, would be for each shareholder to pay a flat percentage of his personal wealth in exchange for his own limited liability in the event that the corporation is sued. This would leave the issue of limited liability in the hands of each individual stockholder. That makes this system somewhat appealing, since each owner of a corporation could decide for himself if he considered limited liability to be important. The downside to this method is that it would heavily intrude into the personal lives of corporate shareholders. To implement it, the government would have to know detailed information about the personal wealth of every individual stockholder of every corporation. This fact raises serious concerns if personal privacy is valued.

A flaw in the current system of corporate income taxation is the fact that corporations pay no tax, indirectly or otherwise, when they make purchases on credit. In fact, many of these purchases would probably be deducted from the corporation's revenues in calculating income tax liability. For instance, if a corporation makes capital expenditures on credit, it would be able to deduct the cost of these purchases from revenues in calculating its income tax. If the corporation later declares bankruptcy, its owners will be protected from personal liability if the corporation were unable to pay the creditors from whom it purchased the capital equipment. This means that the corporation's owners would get limited liability, a contract term they would expect the courts to enforce, but would pay no tax on such purchases because they are deducted in calculating tax liability. Another flaw in the current system of corporate income taxation is the fact that no tax is paid on the contract that arises when corporations engage in debt financing, despite the fact that corporate shareholders are protected from personal liability if the corporation goes bankrupt and cannot pay its lenders.

Since even the current system of corporate income taxation is flawed, it will be necessary to reform it. To understand what reforms of the current system are needed, an ideal system of corporate taxation will first be discussed. This ideal form of corporate taxation would be neither an income tax nor a sales tax, but a *contract* tax. The party that would be suing in the event of breach of contract must pay a tax on the consideration it received. There are three types of contractual relations that a corporation engages in that are relevant in assessing a VCT.[24] First is the contract that a corporation engages in when it sells its products to consumers. The contract here is for limited liability in the event that the purchaser of goods is injured due to the corporation's negligent preparation of the product, e.g., Butcher Bill negligently preparing meat that causes it to spoil. The corporation must pay the VCT because in the event it were sued and the consumer got a judgment against the owner's personal assets, then the owners would have to sue in court for breach of contract because the consumer had contractually agreed to be limited to suing for the corporation's assets. The corporation's owners would be the parties suing for breach in this case, so they must pay the VCT. Rather than being two separate actions, one for the corporation's tort and one for the tort-claimant's breach of contract, the courts could probably combine the two actions. The corporation would simply assert limited liability in the damages phase of the tort action.

[24] I am going to call this ideal form of corporate taxation a corporate Voluntary Contract Tax (VCT).

The second type of relevant contract here is when a corporation borrows money, whether from a bank or by issuing bonds. In this case, the creditors would sue for breach of contract if the corporation didn't pay its debts. A term of the contract would be limited liability. Courts should not interpret contracts in a manner contrary to a reasonable interpretation of their terms. For this reason, even though the creditors would be suing the corporation in the event that it didn't pay its debt, the court would limit damages to corporate assets because that was a term of the contract. Unlike the contract for limited liability in the event of a tort action by an injured customer, the corporation would pay the limited liability aspect of the VCT for a loan indirectly. Since the creditor knew that the contract was for limited liability when he entered into it, he presumably adjusted up the consideration he would demand for lending the money to the corporation. This would mean that the corporation pays more to the creditor in interest on the loan, and this means that the creditor pays a greater amount of VCT to the government. For instance, a creditor might have been willing to give a loan of $100 to the owners of a business for ten days if they repaid $110 at the end of that period. Part of what the creditor considered in deciding to make the loan at these terms was the value of the personal assets the owners of the business possessed. In the event of breach he could seize these personal assets in satisfaction of the debt owed. However, other things equal, if the owners of the business made limited liability a provision of the loan contract, then the creditor would have required them to pay $120 at the end of ten days for a loan of $100 in the present. The extra $10 that the owners of the business must pay represents the compensation that must be paid to the creditor for the risk that the corporation would be insolvent and the creditor could not seize the owner's personal assets. Imagine that the

VCT is 10% of the consideration received by the party that would sue in the event of breach. On the loan contract that didn't involve limited liability, this would mean that the creditor would pay $1. On the loan contract with limited liability for the business owners, the creditor would pay $2. The creditor would also presumably adjust the contract price to reflect the amount of tax that it must be pay.

The third type of contract relevant here is corporate purchases *on credit*. If a corporation pays cash in advance for a product, then the party providing the good or service to the corporation would not have any basis for a future breach of contract suit. The issue of limited liability would never arise. A vender could only potentially sue if it sold the corporation a product on credit and the corporation subsequently failed to pay. Like the second case of loans to a corporation, the vendor to the corporation would have a contract to enforce and would therefore pay the VCT, but the courts would enforce the contract "as is". Part of this contract would be limited liability. Like the second type of contract discussed, the consideration demanded by the vendor would be greater to compensate him for the risk that the corporation would be insolvent. This means that the amount of tax paid by the vendor in the form of the VCT would be greater. The greater amount paid to the government, when other things are equal, would correlate with the limited liability aspect of the contract. The vendor would know the percentage amount of the VCT and would take this into consideration when setting his prices for sales on credit. The corporation would therefore indirectly pay for the extra VCT associated with limited liability.

It should be noted at this point that employees of a corporation are often paid on credit for the labor they furnish the corporation. Unless employees are paid in advance for future work, they are creditors of the corporation.[25] For instance, if an employee of a corporation is paid at the end of every week that he has worked, then he is a creditor of the corporation on the weekdays that lead up to payday. An employee that is not paid on time can sue the corporation for breach. But, like any other creditor, the employee must pay a VCT on this contract. The employee is free to not pay this VCT, but the courts will not enforce his employment contract in the even that the corporation does not pay him. Furthermore, an employee can choose not to work for businesses with limited liability, but if he chooses to do so, then he is bound by the terms of that employment contract and cannot seize the owner's personal assets if they fail to pay him. The fact that employees of a corporation are often creditors of the corporation means that they would pay a percentage of their wages to the government. This should be

[25] My thanks to Kevin Barefield, kbare7@hotmail.com, for this point.

viewed as a voluntary tax on a contract that exists between the corporation and the employee.[26]

A corporation should only need to pay a tax on any sale or purchase that involved a contract for limited liability on the part of the corporation's owners. This "corporate Voluntary Contract Tax" would be assessed for each individual transaction of the corporation. The corporation would not always pay the VCT for all of its contracts. Who pays the tax depends on who would sue in the event of breach. In a contract where the corporation would sue in the event of breach, the corporation would have the option of paying the VCT or not. If it didn't pay the VCT, its owners would be personally liable in the event it was sued, the lawsuit was based on that particular contract, and there were

[26] It should be noted that employees of businesses without limited liability would also pay a VCT if they were being paid for past work rather than for future work, but, other things equal, an employee of a business with limited liability for the owners would pay less in VCT than an employee working for a business without limited liability, since the corporate employee would demand a higher wage to compensate him for the risk of limited liability.

insufficient corporate funds to satisfy the judgement. In practice, rather than sending the VCT on each, individual contract to the government, it would probably be easier for the relevant party to notify the proper government officials within a certain time period of making the contract along with the computed VCT liability. They could then annually or semiannually send a lump sum of money to the proper government authorities for all contracts made within that time period. If they failed to make annual payments of the total VCT's owed for that period, then the government could sue in civil court for back-taxes and interest. In addition to a civil suit by the government, it might also be appropriate for fines to be imposed against the tax evader.[27]

[27] This is an open question in my mind. A civil suit may be the only appropriate government action in the event of failure to pay VCT's owed, but this can be discussed at a later time.

Now that an ideal form of corporate taxation has been described, steps for reforming the current system of corporate income taxation can be discussed. This list of reforms will be presented in an order that should roughly correspond with their chronological implementation. However, it may be that some of the proposed reforms could be implemented sooner than they are necessarily presented on the list. A top priority is the elimination of the individual income tax. Whether this must be done before any other reforms can be made is an open issue, but it should be near the top of the list of reforms necessary in moving towards the corporate VCT. Even if no other reforms were made, elimination of the individual income tax would be a major step towards voluntary taxation, since corporate income taxes are only paid by corporations, and businessmen have the option to do business in other forms of business association. This means that the corporate income tax would reflect, to some degree of correlation, a tax on the limited liability aspects of a corporation, which have already been shown to be contractual in nature, and therefore taxable as a contract that corporate owners would want the government to enforce. Another reform is the gradual elimination of the current deductions allowed under the corporate income tax. This should be done slowly over time to reduce the economic hardships that might be produced by sudden, radical changes in the tax law. Eliminating the deductions is necessary because allowing corporations to deduct purchases made on credit means that they do not pay tax on the limited liability that is an implicit aspect of all corporate purchases on credit. Third, corporations should be required to begin calculating income taxes owed on individual sales. The tax calculated could then be transmitted to the proper government officials, and the sum total of the taxes from the individual sales could be sent to the IRS at the end of the year.

Advances made in computer and telecommunications technologies would obviously make this system of VCT notice to the government easier than it would have been a hundred years ago. Relevant technologies for implementing this reform should therefore be considered to increase efficiency. Fourth, the tax law should be changed to require those selling to corporations on credit to make a flat-percentage-rate payment on the sale to the government. This would reflect the fact that they desire the courts to enforce the contract in the event of non-payment by the corporation. This tax must be paid regardless of how anyone is dealing with the corporation or in what business form. All that matters is that they have made a sale on credit and may require contract enforcement in the future. This tax should be voluntary, but the courts will not enforce their contract in the event that the corporation breaches. Furthermore, the law should be changed to impose a flat percentage rate tax on any loan contract with a corporation. The taxation of corporate loans and purchases on credit is essential to the VCT plan because limited liability of the corporate shareholders against these creditors is one of the key advantages of doing business in the corporate business association. The party actually paying the VCT in this case is the person or business lending money to the corporation, but the corporation would presumably pay more in interest to the lender to reflect the higher VCT paid. The above-mentioned system of notice to the government proposed for corporate sales would also apply to corporate purchases on credit and corporate loans. But, the vendor or lender to the corporation would be the party to notify the government of the tax-liability incurred if they want their contract to be enforced.

The Declaration of Independence says, “That to secure these Rights [to life, liberty, and the pursuit of happiness], Governments are instituted among Men, deriving their just Powers from the Consent of the Governed…”. Unlike other institutions among Men, governments do not produce anything that is *economically* valuable. Most plans for financing government in the past have therefore relied on some element of coercion. Any system of government finance that relies on coercion creates an internal conflict within that system of government, which is supposed to be the institution that protects individual rights. This paper will hopefully provide future government officials with a more detailed plan for a system of government finance that does not depend on the violation of individual rights in order to secure them.